REVIEW OF SBA 504 PROGRAM

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

WASHINGTON, DC, MARCH 9, 1995

Printed for the use of the Committee on Small Business

Serial No. 104–17

U.S. GOVERNMENT PRINTING OFFICE

89–177 CC WASHINGTON : 1995

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-047698-4

REVIEW OF SBA 504 PROGRAM

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

WASHINGTON, DC, MARCH 9, 1995

Printed for the use of the Committee on Small Business

Serial No. 104–17

U.S. GOVERNMENT PRINTING OFFICE

89–177 CC WASHINGTON : 1995

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-047698-4

COMMITTEE ON SMALL BUSINESS

JAN MEYERS, Kansas, *Chair*

JOEL HEFLEY, Colorado
WILLIAM H. ZELIFF, JR., New Hampshire
JAMES M. TALENT, Missouri
DONALD A. MANZULLO, Illinois
PETER G. TORKILDSEN, Massachusetts
ROSCOE G. BARTLETT, Maryland
LINDA SMITH, Washington
FRANK A. LoBIONDO, New Jersey
ZACH WAMP, Tennessee
SUE W. KELLY, New York
DICK CHRYSLER, Michigan
JAMES B. LONGLEY, JR., Maine
WALTER B. JONES, JR., North Carolina
MATT SALMON, Arizona
VAN HILLEARY, Tennessee
MARK E. SOUDER, Indiana
SAM BROWNBACK, Kansas
STEVEN J. CHABOT, Ohio
SUE MYRICK, North Carolina
DAVID FUNDERBURK, North Carolina
JACK METCALF, Washington

JOHN J. LaFALCE, New York
RON WYDEN, Oregon
NORMAN SISISKY, Virginia
KWEISI MFUME, Maryland
FLOYD H. FLAKE, New York
GLENN POSHARD, Illinois
EVA M. CLAYTON, North Carolina
MARTIN T. MEEHAN, Massachusetts
NYDIA M. VELÁZQUEZ, New York
CLEO FIELDS, Louisiana
WALTER R. TUCKER III, California
EARL F. HILLIARD, Alabama
DOUGLAS "PETE" PETERSON, Florida
BENNIE G. THOMPSON, Mississippi
CHAKA FATTAH, Pennsylvania
KEN BENTSEN, Texas
KAREN McCARTHY, Missouri
WILLIAM P. LUTHER, Minnesota
PATRICK J. KENNEDY, Rhode Island

JENIFER LOON, *Staff Director*
JEANNE M. ROSLANOWICK, *Minority Staff Director*

CONTENTS

REVIEW OF SBA 504 PROGRAM

THURSDAY, MARCH 9, 1995

House of Representatives,
Committee on Small Business,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m., in room 2359-A, Rayburn House Office Building, Hon. Jan Meyers (chairwoman of the committee) presiding.

Chairwoman Meyers. The committee will come to order.

Today the Committee on Small Business will be hearing testimony regarding the Small Business Administration's Section 504 Lending Program. Through the 504 Program small businesses gain financing for capital improvement, bricks and mortar work, through a unique cooperative effort among bankers, nonprofit certified development companies, and the SBA. This cooperation, coupled with a requirement for job creation, has made the 504 Program a solid tool for economic development.

Over the years the 504 Program has required little maintenance. However, in last Congress the SBA reauthorization acted to streamline the 504 loan approval process. Also the SBA recently decertified a number of CDC's under their Associate Development Company Initiative. We look forward to hearing about how these changes have affected the program and whether more needs to be done.

Our first witness this morning will be Mary Jean Ryan, associate deputy administrator for economic development at the Small Business Administration, and I think, Mary Jean, if it is all right, we will hear from you and then move immediately to our second panel and then have questioning of everybody all at once at the end, because I think some of the responses that come to questions from the members from the other panel members you may want to comment on.

So let's start with Mary Jean Ryan.

TESTIMONY OF MARY JEAN RYAN, ASSOCIATE DEPUTY ADMINISTRATOR FOR ECONOMIC DEVELOPMENT, U.S. SMALL BUSINESS ADMINISTRATION, ACCOMPANIED BY DOUG CRISCITELLO, DEPUTY ASSOCIATE DEPUTY ADMINISTRATOR FOR MANAGEMENT AND ADMINISTRATION; JOHN COX, ASSOCIATE ADMINISTRATOR FOR FINANCIAL ASSISTANCE; AND LEANN OLIVER, ACTING DIRECTOR, OFFICE OF RURAL AFFAIRS AND ECONOMIC DEVELOPMENT

Ms. Ryan. Good morning, and I would like to ask that my full written statement be submitted for the record.

Chairwoman MEYERS. Without objection.

Ms. RYAN. I want to thank you very much for inviting me to appear before you this morning to talk about SBA's 504 Program. Perhaps the 504 Program is one of the best examples in the Federal Government of a public-private partnership.

I am accompanied today by John Cox to my right; he is the head of our financing programs; to my left is LeAnn Oliver; she is the acting director of the 504 Program; and Doug Criscitello, to my further right, our agency's budget expert.

I am especially glad to be with you today to talk about the 504 Program since it is a program that I know particularly well. As you may or may not know, I had been a director of a certified development company for 6 years in the State of Washington and got to know the program quite well during that time.

Before we move to the specifics of the 504 Program, I just want to talk a little bit about access to capital. From all indications, it seems evident that small firms need better access to capital, and it is equally clear that small businesses are so diverse that if we are going to respond adequately to the need for access to capital, we need a variety of approaches and many different lending tools.

Congress has long recognized this fact, and it underlies why the SBA now offers a full range of small business financing tools from the real small loans for the microenterprises to million-dollar SBIC investments. SBA's "product line" offers a full spectrum of small business financing.

Today we are addressing the 504 Program, which is vitally important because it provides long-term fixed rate financing typically for buildings or heavy equipment. This program exists and needs to exist because the private market does not adequately provide financing for these purposes. There are several reasons why lenders don't make these types of loans. In most markets today the banks operate with fairly conservative loan-to-value ratios. The typical bank terms in the market today are between about 66 percent to 80 percent loan to value. This means that for the small business the lenders require very, very high down payments, typically 20 to 30 percent or more, before they will loan money to a small business to buy equipment or facilities. This cash requirement is very likely to mean that the project won't move forward. Imagine how few Americans would own homes today if home buyers had to make a 30 percent down payment when they were buying their first home.

The second reason that banks don't typically make these types of loans is that banks are frequently unable to make the long-term and especially the fixed-rate loans. Banks make their money by lending at higher interest rates than they pay for deposits, and their deposits are mostly short term. Because there are often large fluctuations in rates over time, banks cannot make long-term fixed-rate loans without exposing themselves to big losses.

From the borrower's standpoint, the variable rate as well as the short term exposes the borrower to an unpredictable payment schedule that can stifle its future growth or could contribute to the collapse of the business. The 504 Program allows a borrower to know exactly what its monthly payment will be for the entire 20-year term, thus allowing the business to plan prudently for its future.

I am now going to use our charts briefly and do a short run-through of how this program actually works. As you mentioned, there are a lot of entities involved, and I thought it might be useful.

[Chart.]

For our chart we called our small business Acme Business Corporation. Let's say that Acme, like a lot of small businesses, needs to get financing in order to expand its production facilities, and let's say, for example, that Acme's project would cost about $1 million. So, Acme faces the question of how it is going to finance this expansion.

In the 504 Program, Acme would connect up with its certified development company. Certified development companies are one of the linchpins of this program. They are locally based, nonprofit organizations. They have boards made up of people from their community, usually business people, economic development officials, bankers, and the like, and the board hires a professional staff who knows about small business financing and are particularly expert in putting 504 transactions together.

So Acme goes to the CDC, and the CDC works with Acme to put its package together. Usually this involves going to a local lender and getting a loan from the bank for 50 percent of the project's cost. The CDC issues a debenture which is 100 percent guaranteed by the SBA.

There are about 280 CDC's around the country, and each month all the debentures that are ready for sale are put into a pool. The pool is sold through Wall Street underwriters with the private investing community buying these Government-guaranteed debentures. Private funds come through the sale mechanism to the CDC, which then loans these funds to Acme, for 40 percent of the project's cost. Finally, Acme itself puts in the remaining 10 percent.

This model represents a good way to think about this program, 50 percent from the bank, 40 percent from the CDC backed by SBA, and then 10 percent from the business.

This entire flow of funds is done for an incredibly low cost to the taxpayer. We talk a lot in these different presentations about SBA loan programs and their subsidy rate or the cost to the taxpayer. This program is particularly efficient in its use of taxpayer funds. It only costs the taxpayer 57 cents for every $100 of debenture financing. That's only 57 cents for the SBA portion of this deal, and the taxpayer also gets the additional benefit in the 504 Program of the leverage that is provided by the bank coming into the deal.

[Chart.]

This chart points out the leverage in a slightly different manner, but before we talk about that again I just want to stress the low cost of the 504 Program. In 1994 the program cost the taxpayers $6.6 million. That is the appropriated dollar amount for the 504 Program, and when you look at the leverage it achieves, the total project financing altogether adds up to $3.5 billion in small business financing.

This chart shows you the growth of this program. There is a lot of demand out there for fixed-rate, low down payment financing for small businesses. It is not something that they can get from the

banks, and it is a very cost-effective way for us to provide this type of financing for small business.

While the cost effectiveness of this program is really quite remarkable, economic development is really the heart and soul of the 504 Program. The CDC's are economic development organizations; that's their mission in their charter; and the program from its very inception has always had a job requirement. It is one job retained or created for every $35,000. Each year the CDC staff people go out and survey the businesses in their portfolio. They acquire evidence of the actual number of jobs that are created by the 504 Program. The number as of the end of September was 344,000 jobs that had been created through the assistance of this program.

Your invitation asked us to also comment on the Associate Development Company Initiative because of the important role of the CDC in the program. In order to assure good program availability throughout this country, the SBA has been reviewing the activities of the inactive CDC's. Last year, 125 CDC's that did not do any significant 504 volume were given associate development company status.

Since a CDC's license essentially gives it a territory in which to operate, the continued presence of inactive CDC's precludes the small firms in that market from getting access to 504. The district offices of SBA without good 504 coverage are now charged with getting a, entire new group to come on line or to work with one of the active CDC's perhaps in a neighboring State or county, and see if they can increase active 504 coverage.

I would like now to turn to the 502 Program which was one of the precursor programs to 504. It is also a fixed asset program, and at this point it is really a hybrid of 504 and 7(a). Because of this and the program's limited funding, the usage of 502 has gone down, and at present the 502 Program is really only working on a very limited basis in two States, Georgia and Wisconsin. In fiscal year 1994 only 54 502 loans were made.

The SBA has analyzed and concluded that the 502 Program has outlived its usefulness. The subsidy cost, the taxpayer's cost, again, for 502 is three times as high as that for 504. If 502 funds were switched into the 504 Program, many, many more businesses could be assisted.

The current 7(a) and 504 Programs have filled the gaps that 502 was designed to fill, and for these reasons and others which I am happy to go into later if you are interested, SBA has requested that funding for the 502 Program not be continued in the 1996 budget.

Finally, I would like to address the status of our work to implement several of the items passed last Congress. We are making very good progress on these items. First I'll talk about the 503 prepayment issue under the 503 Program, which operated until 1986. The biggest difference between 503 and 504 is the source of funding. Under 503 those debentures we talked about earlier were sold to the Federal Financing Bank. Unfortunately, the 503 loans also had a very onerous prepayment penalty provision, and in the last Congress, Congress passed a measure which would provide relief for the borrowers who still had those prepayment provisions. So, in brief, here's where we are in implementing that.

There are 3,500 borrowers that were affected and were eligible for the prepayment relief; 753 of them have indicated to us in writing that they intend to prepay and use the relief provided; 530 will prepay outright, and 223 indicated that they will want to roll that original loan over to the 504 Program. That was allowed in the statute. All prepayments must be completed by August 10, and we are on time and on schedule in implementing this.

Chairwoman MEYERS. Are those numbers in your testimony?

Ms. RYAN. Yes, they are in more detail actually.

Chairwoman MEYERS. Good.

Ms. RYAN. Additionally, last year's legislation authorized the creation of two additional streamlining mechanisms, the Accredited Lenders Program and the Premier Certified Lenders Program. If you are familiar with the 7(a), these are modeled after the CLP and the preferred lender designations in the 7(a) Program. The Accredited Lenders Program will allow active CDC's with a good track record some discretion in handling some of the processing and servicing actions without SBA involvement. We have finished the drafting of these regulations. The premier lending authority gives select CDC's the authority to obligate the SBA's guaranty in exchange for the CDC putting some of their own funds at risk. We are in the final stages of drafting these regulations.

Madam Chairman and committee members, that concludes my prepared remarks, and I will be happy to answer questions following the other panel members.

[Ms. Ryan's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much, Ms. Ryan, and I have indicated that I would like to have the second panel come to the table now, and so if they can do that at this time then we will have questioning all at one time, and I thank you very much for your testimony.

Mr. Cox, and Mr. Criscitello, and Ms. Oliver, I assume that you will be available for questioning too later.

I think we will go right down the table. We will have a timer, and it will be set for 5 minutes, and when the light turns red I don't want you to stop in the middle of a word or anything, but at that point in time if you could wrap up as quickly as possible so that we can get all the way through, and then maybe we will have a little more time for questions.

Mr. Kenneth Lueckenotte—am I pronouncing that correctly?

Mr. Kenneth Lueckenotte is the executive director of Rural Missouri, Inc., and president of the National Association of Development Companies.

Mr. Lueckenotte.

TESTIMONY OF KENNETH LUECKENOTTE, EXECUTIVE DIRECTOR, RURAL MISSOURI, INC., AND PRESIDENT, NATIONAL ASSOCIATION OF DEVELOPMENT COMPANIES

Mr. LUECKENOTTE. Good morning, Madam Chairman and members of the committee. Thank you very much for inviting me to appear before you today to talk about the SBA 504 Guaranty Program and its impact on small businesses across the United States.

Chairwoman Meyers, with your permission I would like to summarize my testimony but have the complete written testimony be submitted for the record.

Chairwoman MEYERS. Without objection.

Mr. LUECKENOTTE. At a recent hearing of this committee on the role and mission of the Small Business Administration, Congressman Hefley suggested that in this time of budget austerity we need to look very closely at what SBA does to facilitate small business. He indicated that Congress must have the courage to cut wasteful or ineffective business programs. What does SBA do to facilitate small business and are there wasteful programs in SBA that should be eliminated? Those are two questions that he asked, and I am delighted today to discuss the 504 Program and respond to those specific questions.

What does the 504 Program do to facilitate small business? It affords small businesses the opportunity to get 10- or 20-year, fixed-rate financing. The 504 Program is virtually the only program in the United States for small business to obtain 10- or 20-year financing. It allows the small business to conserve their cash for working capital and for future growth, and it also enables them to compete in the marketplace with the bigger businesses that they are up against. Without the 504 Program, their expansions or business startups or relocation, whatever the need may be, would have either been scaled down or not done at all, and this is a cost to the society, a loss of jobs, a loss of revenue base for the local communities, the State, and the U.S. Government.

In my particular certified development company which operates throughout the State of Missouri, we finance businesses that are starting up, that are expanding, that are relocating for one reason or another, need to relocate because they have outgrown the space that they are in; we use it for the eligible things of this program.

Is the 504 Program a necessary program, and is it cost effective? It certainly is. In a recent study completed by the General Accounting Office of some $16 to $17 billion in the marketplace for long-term lending, approximately 60 percent of that was guaranteed by SBA. In other words, SBA accounts for well over half of the long-term lending that is in the marketplace today. The reason for this, banks receive short-term deposits. With those short-term deposits they do not want to make long-term loans. The 504 is an inducement for the banks to do some longer-term lending. I think this short-term deposit, long-term lending problem was evidenced in the S&L crisis of the late 1980's.

Is it cost effective? The leverage of this program, as Mary Jean Ryan talked about, is 400 to 1. For every dollar of appropriated Federal budget, we are creating $400 of private capital in the marketplace. Last year, or this current year, for an $8 million appropriation we are going to put $3.5 billion of capital into the marketplace, benefits to the economy and to the taxpayer. With this program we have financed 20,000 businesses, creating some 350,000 jobs.

Just from these payroll taxes alone, from these jobs, if you look at the FICA taxes that are withheld from a salary, the employer's share of FICA taxes, and an estimated income tax on 30 percent of that salary, in the first year alone we return 6,000 percent to

the Federal Government. For the $8 million this year, the estimated payroll taxes paid back to the Federal Government would be about $480 million. In addition to that, the local businesses pay State income taxes where appropriate, Federal income tax, and it also creates the taxes for the local economy through property taxes.

Can the 504 Program be further privatized? Not much. In 1980, as Mary Jean pointed out, the program was financed through the Federal Financing Bank. In 1986 it went to the private markets, and, as we pointed out, the leverage currently is tremendous. For every 57 cents we create $100 of funding through the 504 Program alone.

Can it become more efficient? Can we reduce the Federal deficit by making some changes to this program? We can. We have been working with the agency over the last several years to improve the program. As Mary Jean pointed out, we have implemented the Accredited Lender Program; we are in the process of implementing the Premier Certified Lender Program; we are working with the agency to streamline the program, to automate the program, and certainly improve the efficiencies. We are also currently in the process of implementing an expedited closing process. All of these things would minimize the work load on SBA staff. Along with the Premier Certified Lender Program, we are proposing to go to a centralized processing system which, again, would minimize the work load on SBA staff.

The program already is the lowest cost program within the SBA. At a subsidy rate of 57 basis points, it is extremely effective. However, we would be willing to do our part to reduce this even further. One example would be to increase the interest rate spread to the small business concern. We say this with caution because these businesses still must be able to obtain affordable financing that they can compete in the marketplace. But, for example, the loans that were funded last month at 8.8 percent, if the interest rate were 8.85 to them and its additional interest were earmarked for a special loss reserve fund, that increased cost to them would not be dramatic but over the life of the loan it would generate a half percent for loss reserve.

Chairwoman MEYERS. Mr. Lueckenotte, could you summarize within a minute or so?

Mr. LUECKENOTTE. OK. Thank you.

In summary, in the current year we are looking at a need for approximately $1.6 billion based on the current usage. We would ask for the committee's support in reprogramming from other funds if necessary or some other assistance to meet the demand.

In fiscal year 1996 we anticipate, based on the current growth rate, a need for approximately $2 billion in loan authority. This would be a budget appropriation of approximately $11 million. This would enable some 6,000 businesses to receive assistance. It would leverage $4.5 billion in the private markets.

Chairwoman Meyers, thank you for the time, and I would be happy to answer any questions you or the committee members might have.

[Mr. Lueckenotte's statement may be found in the appendix.]

Chairwoman MEYERS. We appreciate your being here very much.

Our next witness is Mr. Jeffrey Donaldson, vice president of Northwest National Bank in Vancouver, Washington, a bank with an excellent history of 504 participation.

Mr. Donaldson, and I would mention that the mikes aren't very sensitive. If you could get as close to them as you possibly can, that would be helpful.

TESTIMONY OF A. JEFFREY DONALDSON, VICE PRESIDENT, NORTHWEST NATIONAL BANK, VANCOUVER, WASHINGTON

Mr. DONALDSON. Thank you.

Good morning, Madam Chairman and members of the committee. It is a pleasure to be here this morning. I have also prepared a written statement I would like to have inserted into the record.

The primary question to which you are seeking an answer I'm sure, is: Is the 504 Program really necessary? Yes, it is. A simple question, a simple answer.

Small businesses have found it almost impossible to find real estate loans at interest rates and terms that they can afford. At some banks they just do not make available commercial real estate loans irregardless of the interest rate or the terms.

Why aren't banks making available commercial real estate loans? The basic reason is the high risk associated with commercial real estate. There is high potential loss. Commercial properties tend to be special purpose. If the banks end up taking them back, there is high cost in converting them to other alternative uses. There are not very many buyers that want to buy commercial buildings, and the reasons go on and on and on.

Another important reason that banks do not make commercial real estate loans is because there is a high liquidity risk. Most of our deposits can be removed by depositors almost at a moment's notice, and it is very difficult to make long-term loans based on those kinds of deposits. The risk to banks is just is too great. Ignoring this proper matching of deposits and loans is one of the primary reasons of the S&L fiasco a few years back.

Why doesn't Northwest National Bank make conventional commercial real estate loans? We do, but not very many. The reason is because our lending policy requires somewhere between 35 and 50 percent equity depending on the type of loan and the borrower, and we don't get very many takers. Businesses cannot afford to have all of their liquidity tied up in a commercial building. We also don't make low equity loans because we are a small bank and the risk is just too high.

How is Northwest National Bank using the 504 Program? One way we have used it is primarily to help our credit-worthy customers to whom we would have never made a commercial real estate loan. Without the 504 loans we would not have made these loans.

In the past 2 or 3 years that I have been at Northwest, we have put on about $11 million worth of 504 loans and we have also used the 504 Program as a business development tool. Many of our competitors are not very savvy about the program, and it has helped us pick up a lot of new business. It also has enabled us to make more loans because we don't have to finance 100 percent of the

loan request. The SBA helps us with 40 percent of it. Said another way, it helps us to spread our capital.

We also use the 504 Program to enhance bank liquidity. Our portion of the 504 loans can be sold into the secondary market, and we are also able to entice other banks to cooperate with us on loan participations because of the high quality of these loans.

Does the 504 Program provide real benefit to the economy and the taxpayers? In my opinion, yes. The 504 Programs in which Northwest National Bank has been involved have resulted in the following: One, they have put in somewhere between $11 and $15 million worth of work for contractors and the related businesses that spin off of that. SBA 504 loans have enabled our customers to grow larger and become more efficient, which has resulted in larger and better customers for the bank. We have seen the creation of new jobs. We have also seen growth in the local tax base because of the new facilities that have been put up. SBA 504 loans also create high-quality, low-risk loans for the bank.

What is my overall assessment of the 504 Program, and should it be continued? I think it is a great program. Yes, it should be continued. Why should it be continued? Because it works. It is an effective program that works. It helps small businesses obtain commercial real estate loans that they wouldn't get otherwise. The program is aimed at owner users, which to the bank are the lowest risk borrowers that we can find. Therefore, by the program's very nature, it is going to succeed.

Does the program require any improvements or changes? Not really. The program works well just the way it is, and in essence I wouldn't change anything.

In conclusion, I feel the SBA 504 Program has made the difference for my customers every time it was used, and without the 504 Program they wouldn't have got the loans that they needed. It is certain that without the 504 the viability of their businesses would have been affected.

Thank you very much.

[Mr. Donaldson's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much for being with us and for making a long trip to be with us, Mr. Donaldson.

Our third witness is Ms. Katharine Delahaye Paine of Portsmouth, New Hampshire. Ms. Paine is the founder of the Delahaye Group, Inc., and at this time I would like to introduce into the record a letter from Representative Bill Zeliff welcoming Ms. Paine. He could not be with us today. He is chairing a hearing at his Government Reform subcommittee and regrets that he cannot be here.

Ms. PAINE. Thank you.

[The letter may be found in the appendix.]

Chairwoman MEYERS. So, Ms. Paine.

TESTIMONY OF KATHARINE DELAHAYE PAINE, CEO, THE DELAHAYE GROUP, INC., PORTSMOUTH, NEW HAMPSHIRE

Ms. PAINE. Thank you very much, Madam Chairman, and, again, I am very pleased to be here, and I would ask that my written summary be introduced into the record.

Chairwoman MEYERS. Without objection.

Ms. PAINE. You have heard a lot of numbers here today about what the SBA and the 504 Program in particular has done for large quantities of businesses, but this is really a very personal thing for me. I really shouldn't be in business.

I started my business 8 years ago. I was a journalist. I had no business experience. It was the middle—just about to be the middle of a recession, and I was starting a business that nobody understood. I knew that there was a market out there for a service that would evaluate corporate image and the effectiveness of marketing programs. Having been in marketing for a number of years, I knew that millions of dollars were being wasted and companies just didn't know exactly what they were getting for their money. I thought I could do this out of my dining room table with a computer and a laser printer, and it very quickly became apparent that I couldn't do that.

The problem was that I really didn't have any business sense, I didn't know how to go about getting a loan, I moved to New Hampshire, and it never occurred to me that I would have any difficulty. Well, of course, being a woman with no business record and no track record, there was a great deal of difficulty. People laughed at me. They thought I was crazy.

But the truth was, because the SBA existed, Bank of New Hampshire on a cold winter day said, "Sure, go ahead. You can go ahead and buy this building that you want." I had zero in my bank account at that moment, and we ended up buying the building, thinking that we were going to be in there forever.

Within about 5 years we had 24 people in a 2,200-square-foot building; we had completely run out of space. We were growing 40 percent a year, and our clients were not little companies that we had thought maybe might buy our services, but they were companies like IBM, Intel, Apple Computer, and Hewlett-Packard, and they wanted to see this company that was doing the work for them in a proper building. Well, we were operating at that point out of sort of an overgrown trailer in Hampton Falls, and so I knew I had to get a new building and I knew it had to be one that was presentable to the type of clients that we were using.

At that point the S&L crisis was in full swing, the real estate market in New Hampshire had taken a complete dive. The building that I wanted to buy had a long history of questionable financing and had been basically unoccupied for 6 years. The previous restaurant owners had left so fast they left the potatoes in the oven. It has been an abandoned restaurant and basically a house for the homeless and the unsavory elements of Portsmouth for a long time. Nobody wanted to go near it.

It was perfect for me because it was essentially a big old warehouse and we could customize it for our needs, and once again there was the issue of, why should we lend money to this crazy woman who operates this business that nobody can quite figure out, and, yes, she has got some nice clients, but what does she know about real estate development? Again, thanks to the 504 Program, I was able to get the loan and get the financing that I needed.

In about 6 months we took a completely dilapidated building, turned it into an almost 10,000-square-foot first class office space,

and brought 25 new jobs to Portsmouth. That is 25 people eating and drinking and playing in Portsmouth every day that weren't there before, and it also pretty much led a renaissance in Portsmouth, and there are a number of other businesses that have now followed us into town, so it has really done tremendous things to the local economy.

The total project cost was around three-quarters of a million dollars, which was a huge number to me but apparently wasn't that big a number to the SBA and the 504, and therefore they thought it was a great deal and a great project, and it really has been. We have been in the building just over a year. So far in that year—and let me also back up and say that we could not grow at the old building, we could not add any more bodies, which meant we could not take in any additional work.

Since we have moved into the new building, we have basically grown another 23 percent in our staff, our revenues have grown 40 percent, and our profits are up 1,000 percent, which was the best part of it. Nine new jobs in the first year; we will hire another 12 employees this year. We estimate that we will be at about 50 employees within 2 more years and generate about $10 million worth of revenue.

When a company grows about 40 percent a year, you are in a continuous cash flow crunch. I mean anybody who has run a business knows that the biggest problem in small business is cash flow, and as much as our clients are blue chip corporations, the work we do takes about 6 weeks to complete, so there is a tremendous amount of cash flow problems that we are always encountering, and we could never have come up with a 20, 30, or 40 percent down payment on a building. The way the 504 Program was structured enabled us to do it with literally what we had in the bank at the time and never would have happened any other way.

The statistics side of what we do is that we currently are employing about 34 people full time, but then there are another 50 people part time that we pay, subcontractors. That adds up to about $225,000 in Federal and State taxes on $1 million payroll, and we sit there in Portsmouth, and we influence spending of millions and millions of dollars through 3M and Proctor & Gamble and IBM and all of our clients.

The 504 Program has really been a very important part of New Hampshire's growth rate. About 5 years ago we did an analysis of New Hampshire's image in the press, and the State was best known for having the worst economy of the country. Our analysis today says basically that New Hampshire is well on the way to recovery, and an awful lot of that is because of the small businesses and because the small businesses are successful. The reason the small businesses are successful is because of the SBA in many, many cases.

So I really am here because I think that the 504 Program is not a Government handout, it is an incredibly effective, efficient way to give small businesses the encouragement and the support that they need to grow, and I do firmly believe that small business is the key to the future right now, and I think that the 504 Program is one of the ways that for very, very little cost the Federal Government can actually help the economy and the small businesses.

Thank you.

[Ms. Paine's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much, Ms. Paine, for your tremendous success story. We are glad to have you with us today.

Our next witness is Mr. William Ruettgers—am I saying that right?

Mr. RUETTGERS. Yes, ma'am.

Chairwoman MEYERS Of Charlotte, North Carolina. Mr. Ruettgers is president of Southern Cast, a small foundry. Mr. Ruettgers will tell us about his need to use 504 when his original plant was taken to expand a highway.

As an interesting note, Mr. Ruettgers employs a number of formerly homeless people, and I want to commend him for his efforts to alleviate poverty through job creation.

Mr. Ruettgers.

TESTIMONY OF WILLIAM RUETTGERS, PRESIDENT, SOUTHERN CAST, INC., CHARLOTTE, NORTH CAROLINA

Mr. RUETTGERS. Thank you very much for inviting me here, and I would like to have my testimony put in the record.

Chairwoman MEYERS. Without objection.

Mr. RUETTGERS. I just want to try to explain what the 504 plan did for us. I lived normally in Pittsburgh, Pennsylvania, and moved to Charlotte with two other gentlemen and bought a small foundry that had 11 employees. Those 11 employees were not homeless people, they just were employees that worked for a small company. My partners wanted to get out of the business, so they left, and we were left with the small company.

We were located under a major bridge right in Charlotte that was going to be expanded someday. We sent the State a nice letter asking them if they could give us a hardship and try to negotiate a buy-out with us early because it was hurting our growth. It was hard to ask prospective customers to come with us knowing that we would have to relocate in a couple of years. Relocating a foundry is not that easy because of the heavy equipment and whatever.

So the State was very willing, and we negotiated a fair deal. But after the deal was completed and after I had paid off all my debt, I had very little cash left over. I had a lot of equipment, but no building. So, I went to all the banks in the area, and they all looked at me and said,"Yeah, you can maybe start in another garage if you want, somewhere under a bridge or something, that's the best you can do."

So I had an opportunity to meet Fred Miller with the Charlotte Certified Development Corporation. With his help I got a 504 loan. I really mean with his help because I'm a high school graduate and that is it. I had no knowledge whatsoever on how to do this. Fred got with a small bank called Southern National, and with their help and also with Duke Power's help in finding me a building, gave me the opportunity to stay in Charlotte.

Staying in Charlotte in our environment is kind of different. We now hire 36 employees, and we are proud of it. Our last 20 employees have been homeless, and when I say homeless I mean living in a box. I'm talking real homeless, I'm talking with problems that you can't even think about. None of our employees live on the

street right now. We help them get hotels, we help them get a place to live. If they are with me for a long period of time, we help them get automobiles. We have fantastic benefits—hospitalization, pension program, paid vacation, paid holidays, paid bonuses. We give a bonus just for coming to work because the hardest thing is just to get them to work.

Without the SBA 504 Program, I could not hire these people. There is no doubt in my mind that I could find a job, and I'm sure my sons could, and I'm sure a couple other of my employees could. But 20 or 30 of my employees could never find a job. Most people would not hire them just because of their appearance.

They show up to work. They are the type of people you may not hire, but in my work they are probably the best people I could hire. They have a strong will; they are willing to work. I have employees that never worked in their life that have not missed a day's work in 5 years. Not a whole lot of people can say that, including most of you, including myself.

We have grown with the 504 Program. We are located in an area of Charlotte that is close to the homeless shelter. We are close to OSHA, and we are only ½ mile from downtown. We renovated a $70,000–$80,000 building, and moved all our equipment. If we wouldn't have had that opportunity with the 504, there are 20 or 30 employees that the Government may be supporting. Our employees are now paying their child support, which they could never pay before. They are not on any type of Government subsidy whatsoever. I don't apply for any Government subsidies when I hire them. I don't ask for any benefits that the Government would offer me.

We don't only hire homeless. Other people come in and apply for a job, but it just seems like the homeless are the people who have a lot of street sense. If you ever visit a foundry, you will see hard workers. I work if I don't sell castings. It is a very physical type work. You don't need an educational background, you just need a lot of hard work. I think the 504 plan gave us an opportunity to put a lot of people to work that would not have jobs today.

Everybody has a vision, and we have given these people and myself a vision to really see something. I think that personally we probably owe you more thanks than we owe the 504 because if you wouldn't have put this system in, we would have never had the opportunity. So, I thank you. I owe you as much thanks as I owe them, and I am one proud person to do what we are doing. I just want to thank you and thank the 504 for having me here and hearing my story.

Thank you.

[Mr. Ruettgers' statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much, Mr. Ruettgers. We appreciate your being with us.

Our next witness is Mr. John Jensen, and he has a different perspective. He is the owner of a former motel in Iowa. Has a different impression of the 504 Program and will share his views of some of the serious flaws in the program.

We are glad to have you with us too, Mr. Jensen.

89-177 O - 95 - 2

TESTIMONY OF JOHN JENSEN, FORMER OWNER, MOTEL 60, CENTERVILLE, IOWA

Mr. JENSEN. Thank you. Thank you, Chairman Meyers, members of the committee.

I was financially ruined because of the SBA 504 Program. My story is as follows. In May of 1989 I purchased a motel in Centerville, Iowa, called the Motel 60 and Villa. I had invested a lot of money in it and put up my farm as collateral for a loan. I was making improvements on it, and business was fine until December of 1989 when a Super 8 motel announced it was going to be built. They opened in May of 1990, and by September 1991 I was wiped out. I lost everything—my money, my property, another business, and my reputation as a good businessman—and I am still in debt.

How did this happen? Before I purchased Motel 60, I analyzed what I thought would be the probability of another motel coming to town because I knew the effect would be devastating. My line of reasoning was that a new motel would cost about $750,000 and a bank would want at least a 20 percent down payment. That would be around $150,000. My thinking was that if someone had that much money to invest there would be places better to invest than in Centerville, Iowa. I felt pretty safe.

Under the 504 Program a Super 8 motel was called a job creation project or a community betterment project and the developer only had to come up with 10 percent. That was only $75,000, a small amount in the motel business. If I would have known that my competition could have come in and built for 10 percent down and had the Federal Government back him, I would never have invested in the lodging business.

I have a problem with the way my competition received the loan. He called it a community betterment project, and under the rules he needed written documentation demonstrating significant impact. This consisted of six letters from people who had a vested interest in a new motel. For example, the utility company would sell more power to a new business and a newspaper would sell more advertising space. Not one of the people who wrote the letters could be qualified in any way to judge the need for more lodging in Centerville. They all had opinions when I could have provided them with facts.

I am not the only person who has been ruined by this program. There have been other motels built in Iowa in Lemars, Iowa; Independence; Perry, Sioux Center; Dyersville; and Harlan. I have no problem with the one built in Harlan because it was one that was built to replace a hotel that was torn down. I have talked to hotel owners in Perry and Dyersville, and they have been hurt by these projects. This is just in Iowa, but I wonder how many other businesses have been hurt nationwide.

The people are receiving Federal assistance under false pretenses. They say they are creating jobs, but in reality they are only transferring jobs from one motel to another. In their wake they leave owners in financial ruin. It has to be stopped now. Who speaks for the honest businessman who is taking risks without SBA help?

I thank you for this opportunity to testify before you. I don't mean to attack anyone, but someone somewhere down the line needs to think about how this job creation is working. I know it isn't working out in Iowa.

Chairwoman MEYERS. I thank you very much for your testimony, Mr. Jensen. You raise some questions in my mind, and we will ask them later, and I thank you very much for being here.

Our final witness is Mr. Michael Kehoe, owner of Kehoe Ford in Jefferson City, Missouri. Mr. Kehoe will discuss his success and expansion into Osage Industries.

TESTIMONY OF MICHAEL KEHOE, PRESIDENT, KEHOE FORD, JEFFERSON CITY, MISSOURI

Mr. KEHOE. Yes, ma'am. Good morning, Madam Chairman and the committee members.

I would like to have my testimony submitted for the record as well.

Chairwoman MEYERS. Without objection.

Mr. KEHOE. I start my situation by adding that I found out to have a competitive business in today's environment it would take many things to make a business successful. You have to have good products, a commitment to customer satisfaction, top notch personnel, a strong business plan, and adequate financing. Putting all these items together is rare. Trying to do it when you are young with little experience is next to impossible.

I received an SBA 504 loan and SBA 7(a) loan guaranty totaling almost a half a million dollars when I was 26 years old. If it were not for these programs, many jobs would have been lost, a business vital to a small rural community would have folded, and an annual payroll tax base of over $1 million would have been nonexistent.

I started my business career in St. Louis, Missouri, working as a lot porter for a Ford new car dealership at the age of 18. After washing cars for a year, I earned the opportunity to move up in the organization and became a new truck salesperson. I became the top salesperson in the first year, was promoted to assistant truck manager in 2 years, and became the truck manager in just 4 years. I was the youngest truck manager for a Ford Motor Company dealership in the United States, and at the age of 25 I was awarded the Truck Manager of the Year for the St. Louis Ford District.

In 1987 I was asked by a group of Ford dealers who owned a company in Linn, Missouri, to take it over and try to run it for them. This company was known as Osage Vans, and it was a manufacturer of conversion vans and ambulances in central Missouri. The company had been in business for 5 years, and it was a small company, and it was very important to a small community which has a population of about 1,200 people, mostly farmers and people who need to have a job to subsidize their current process.

When I took the job, the dealers who owned this company felt it was in bad shape and told me that they would like to just close it down and get their money back out of it because it was more of a headache for them at the time than what it was worth.

It was February of 1987 when I went down to this company in Linn, Missouri. We had 27 people and an annual sales of $2.5 million. The company was 5 months into its current year and was

showing a year-to-date loss of nearly $200,000. At first I knew the picture looked bleak, that the dealers were probably right, the company should be closed, but as I met the people who worked for this company I realized their commitment to build quality products and I saw how important the job was to them and I knew somehow we could make it.

With the hard work and dedication of these people, we increased production 50 percent and turned the loss into a profit in just 7 months. I knew I had a winner, but the owners still did not want to be bothered, and I had some other options as well. I was also being contacted by Ford Motor Co. to run one of their dealerships. It was decision time for me. I decided that this company could be a success if the owners would agree to sell. There were many people who were relying on the jobs that this company was providing them, and their families were relying on them as well.

I had very little money at the time, but I had figured I would be able to arrange some financing to put a deal together. The owners agreed to sell, but what it took to put the deal together was a different story. My accountant and I visited all of the local banks in Jefferson City, Missouri, with a sound business plan and a very positive attitude. It wasn't long before the banks quickly showed us the door and told us that they didn't have much faith in me or the ability of this business to survive.

Before we gave up, we visited the Missouri Department of Economic Development. They understood that if we did not put the deal together the company would be shut down and the small 1,200-person town of Linn, Missouri, would lose a major base of employment. The economic development people directed us to Rural Missouri, Incorporated, a certified development company. Rural Missouri would help us work with the SBA which would in turn give the banks something new to consider.

After RMI toured the plant and met with me to explain the 504 Program, they were convinced that the business would succeed with adequate financing. Since I had little cash to invest in the financing, the structure was not a typical one. Rural Missouri invited John Blum of the St. Louis SBA office to see the business and meet with me to listen to my ideas and make the company a success. John explained the 504 and 7(a) Programs could help us obtain the necessary financing. Within weeks the same banks who had turned us down began to listen.

On May 8 of 1988 we closed the deal with the owners to buy the assets of Osage Vans. I had a $250,000 504 loan and a $200,000 7(a) working capital loan and the help of a local bank who believed in me. A new corporation was formed called Osage Industries. The team of managers I formed were ready to go, and a new spirit was evident in the company. People who worked there finally felt comfortable with their future as well as the company's.

At the time the company was producing 35 conversion vans and four ambulances a month. Total employment was approximately 30 people. In the years ahead Osage Industries grew into a major central Missouri manufacturer. Production increased to 100 conversion vans and 10 ambulances a month. The product distribution went from the central United States to all of the United States, Canada, and Mexico. An additional subsidiary company was

formed, and employment grew to over 100 people. Annual payroll rose to over $1.5 million, and sales toppled the $6 million mark.

In 1991 I received the Young Entrepreneur Award from the SBA for the State of Missouri and the Central Region of the United States. Osage Industries has received many awards from Ford Motor Co., General Motors, and Chrysler Corp. for production quality and superior customer satisfaction. I sold this company in 1992 to a group of the managers to pursue my dream of owning a Ford dealership. The group of managers who bought the company were almost all there from the beginning and deserved to be owners. The company remains very successful today with 1994 sales of $8 million and a major role in Central Missouri employment.

The dealership I purchased has grown to over 25 percent in sales in just 2½ years. We needed expansion at this location as well because of the increased service business that was generated by the growth. We turned again to the SBA in 1994 for help with a real estate loan that would include expansion of the facility and room for additional equipment. I worked with the 504 Program for a second time and put the real estate deal together. Our employment level has grown from 85 to 135 people, and the expansion of our facility is what made most of the employment possible.

These loans, as a lot of people like to tell me, are not gifts. I have paid them back. I agree with the people who want to make Government smaller and let business go on with its own course, but I think that there is a very important level for the 504 funding, and, as you have heard from some of the other people, the cost to the Government for this program versus your return is a great one. I would like to see it looked at as an asset and not a liability.

I am not sure what the future holds for these programs. What I am sure about is the need for individuals who have the ability if they get a chance. I got a chance, the people we employed got a chance and, with me, made it work. Small business is what makes America work for yesterday, today, and tomorrow.

I thank you for being here.

Chairwoman MEYERS. Thank you. We appreciate having you with us, Mr. Kehoe.

I am going to ask a question of Ms. Ryan, and I think we are going to arrange to have a chair for you at this end of the table, and so while you are coming to the table let me ask a question for Mr. Jensen.

What does SBA do to take into account whether an SBA loan is going to injure an existing industry, especially in smaller communities, and large? In larger communities that may be very difficult, but is there any kind of a role like that, that CDC people play, that SBA local or regional offices play, Ms. Ryan?

Ms. RYAN. Sure. One of the things, especially in a small community, is that there are lots of sets of eyes on a 504 transaction before it gains approval. There's the CDC's eyes; they don't want to be working on a project that they don't think has a chance to work. In many respects the onus for proof is going to be on the newcomer, because the people in the community would be aware of the services that are provided in that community and would be very sensitive to both not wanting to injure the business and also not feeling that there might be a market for any more. So, when you look

at a 504 transaction you have got the CDC looking at it, perhaps most importantly the bank looking at it——

Chairwoman MEYERS. The CDC, their interest would be in making the loan, would it not?

Ms. RYAN. A CDC would like to see a project move forward, but the first thing they think about is whether the project is viable. Most CDC's are small and must choose the most potentially successful businesses they can. So, the business plan of the new entity is going to get a lot of scrutiny from the standpoint of demand for the service they are providing?

The bank, before it is going to commit to its portion of the deal, is going to look very hard at that same issue: Is there a market for this business? Start-ups and particularly startups that are connected with single-purpose facilities, such as hotels or motels, are very, very hard to finance for that very reason. If there isn't a market then you know that the property would be difficult to liquidate because it is a single-purpose facility, so the bank would be looking very hard at that to see if there is a market that makes the project viable. Then the CDC's application goes to the SBA, and the SBA looks at the project before it puts its guaranty on. So, there are a lot of sets of eyes on that.

I don't know the facts of this particular case, but often people in the community do provide letters, and hopefully they are not all self-interested parties. Often it is the mayor of the city that provides a letter in thinking that a particular project would further the community's economic development strategy. A lot of rural communities now are trying to attract tourism, and a lot of communities are deciding that they want to cluster businesses of a like type because this works better. So, there are a lot of factors.

Chairwoman MEYERS. Thank you very much, Ms. Ryan. We will get back to this later.

Mr. Kennedy.

Mr. KENNEDY. Thank you, Madam Chair.

Ms. Ryan, maybe you could explain. You said in your testimony that a good percentage of all long-term commercial financing is financed through the SBA. Explain how the other financing takes place if it is not for the requirements that the SBA has? In other words, if you are lending at a preferred rate of interest than the other percentage of SBA—the other percentage of long-term commercial financing—how are they able to compete, or are there asset requirements? I have seen the project requirements, and none of it includes specifically, at least in the testimony I have seen, specific asset requirements. I am wondering if you could just explain?

Ms. RYAN. I want to make sure I understand your question. I think it was actually Ken Lueckenotte's testimony. He was referring to recent research that is showing that both the SBA 7(a) Program and 504 together make up a significant portion of all available long-term commercial loans. Is that——

Mr. KENNEDY. Yes, that is right.

Ms. RYAN. I am not a great expert in all aspects of financial markets, but my understanding of the other types of financing that would make up the difference would primarily be for much larger companies which have access on their own to the private markets, usually through the issuance of some type of security, where pri-

vate investors would fund such a transaction for a long term. As we were pointing out, small transactions do not have access to long-term markets and banks, just by virtue of how they work, can't provide that long term.

Mr. KENNEDY. But there must be something in the market that says when you have so many assets you are now able to leverage long-term financing on your own without SBA assistance, and I am sure, with the market being what it is, you can pinpoint it with some assurance. Am I not correct in saying if you have so much, three-quarters of a million dollars worth of assets, you are able to leverage that on your own for so much? Is there a certain threshold that immediately, on the numbers basis, SBA can then kick in and evaluate all these other project requirements—in other words, to kick off the SBA-backed guaranty?

Ms. RYAN. I think some of it has to do with project size, and the nature of the project that is trying to be financed. So, SBA's limitations—like on the 504 portion, the 40 percent portion maxes out generally at $750,000, in some cases at $1 million.

So the larger project sizes, the $5 million type transactions, some of those are being done, for example, with industrial development bonds through State mechanisms.

Chairwoman MEYERS. But I think what—excuse me. If the gentleman would yield.

Mr. KENNEDY. Sure.

Chairwoman MEYERS. I am not sure if I understand the question, but I think it is a good one. I think what Mr. Kennedy is asking is, how do you determine whether you are lending money with a Government guaranty to somebody who doesn't really need it because he has so many assets? Is that what——

Mr. KENNEDY. That is the thrust.

Chairwoman MEYERS. Yes.

Ms. RYAN. Well, the SBA has sort of an across-the-board personal liquidity test, and so both the presence of that criterion as well as the small business size standards, all of these things converge to ensure that you are dealing with a universe of businesses that truly need the financing.

Mr. KENNEDY. Just as a follow-up, after the loan is made, how involved is SBA in managing or helping a small business manage their business plan?

Ms. RYAN. In the 504 Program it is the certified development company that actually—the term we use is "services the loan." They monitor whether the business is making their monthly payments, and on the bank portion the bank services that. So, again, the bank's eyes are on the project as well as the CDC's.

The SBA, as you know, has a lot of business education resources as well, and the CDC's are very attuned and involved in the whole array of SBA offerings, so when they see someone is perhaps getting behind in a payment or something, they do site visits, they talk to them. If they think that the Small Business Development Centers could help them, they call them in or refer them to other local people who might have particular expertise.

Mr. KENNEDY. Good. Thank you very much. I appreciate it.

Chairwoman MEYERS. Thank you, Mr. Kennedy.

Mrs. Kelly.

Mrs. KELLY. Thank you, Madam Chairman.

Thank you all of you for coming and testifying. It is interesting to hear what you have to say. In particular, Ms. Paine, I know what it is to have people look at you and say, "Well, I think you are crazy, and, besides that, you are a woman so you can't have any money." It is tough.

But I am a little confused, Ms. Ryan, about some of the figures you have shown us here on this list because you have down here that the SBA commercial loss rate is .90 percent. I don't know if you mean 90 percent or nine-tenths of a percent. I'm not quite sure what that figure means.

Ms. RYAN. Sure. Sorry. Nine-tenths of 1 percent is the commercial loss rate on the 504 Program. It is less than 1 percent.

Mrs. KELLY. Do you have a figure on how much of a line item budget you are—how much your budget is to administer the 504 Program?

Ms. RYAN. The appropriated dollars through the 504 Program for this year is $8 million, and that is for the actual capital cost. I would be happy to provide for the record the administrative costs, if you would be interested in that.

Mrs. KELLY. Yes.

Ms. RYAN. This program is one of the SBA's lending tools and, as SBA operates it, it is the same loan officers doing the work of the 504 and the 7(a), but we can make some good approximations and get you what would be a good administrative cost figure.

Mrs. KELLY. If you don't mind doing that, I would very much appreciate it.

Ms. RYAN. Not at all.

[The folowing information was subsequently received from Ms. Ryan:]

The SBA's field office structure makes it difficult to apportion overhead/administrative costs because many costs are shared by the entire range of SBA's programs. Using a methodology that is based on our staffing standards, the cost of personnel is roughly $5.2 million.

Mrs. KELLY. One other question if you are going to collect some statistics for me. Could you also please include statistics showing what numbers of women you have supported loans for under 502, 503, and 504?

Ms. RYAN. We would be happy to.

Mrs. KELLY. Would you do that for me please?

Ms. RYAN. Sure.

Mrs. KELLY. Thank you very much.

I don't have any more questions thank you, Madam Chairman.

[The following information was subsequently submitted by Ms. Ryan:]

The following includes 502 and 504 loan approvals (Note: No 503 loans have been approved since 1986):

Year	Number of Loans			Dollar amount of loans		
	Total	To women	Percentage	Total	To women	Percentage
1991	1,552	158	10	$479.3	$42.6	9
1992	2,097	212	10	664.6	53.3	8
1993	2,553	244	10	856.5	65.3	8
1994	3,873	476	12	1,351.0	135.6	10
1995*	1,273	184	14	443.7	56.9	13
Total	11,348	1,274		3,795.1	353.7	

*Through February 3, 1995.

Chairwoman MEYERS. Thank you, Mrs. Kelly.

Mr. Poshard.

Mr. POSHARD. Thank you, Madam Chairman.

Madam Chairman, I would like to ask unanimous consent to submit an opening statement for the record.

Chairwoman MEYERS. Without objection.

[Mr. Poshard's statement may be found in the appendix.]

Mr. POSHARD. Thank you.

I didn't get to hear everyone's testimony, I came in late, but for Ms. Paine, I congratulate you on your courage in getting started out in a business that nobody knows what it is about; and, Mr. Ruettgers, to take a risk on homeless people and to build your business on that, I think that is very commendable. I appreciate what you folks had to say about that. That is a great story.

Mr. Jensen, I just wanted to ask you a couple of questions because I think all of us in legislative bodies like this struggle with the issue of fairness with respect to how Government helps people, or hurts people in your case.

Mr. JENSEN. Yes.

Mr. POSHARD. I know in my home town of Marion, Illinois, a town of 14,000 people, we have a TIF district—what is called a Tax Increment Financing District—which gives advantages to people who locate in that area.

Mr. JENSEN. I know how it works.

Mr. POSHARD. We also have an enterprise zone, or at least I think we do; we have been trying to get one. But I know when we were working on these economic enhancement tools with the State Department of Commerce, Community Affairs, and other economic development agencies, there was a great deal of concern about what it would do to entice these people to come in, to the local folks down on the square, local businessmen.

Now you know, we have a huge Wal-Mart that is located in that zone now. We have got all kinds of other businesses that have come in to take advantage of that, and I suspect some businesses in town that were there before have been hurt by that, some have been helped by the extra traffic, and so on. But what do we do about this? I mean, would we have Government decease any attempts to help with economic development? Do we become more sensitive to people like your own before making direct loans to a person that is coming in that might impact your business?

I mean it really is a tough situation for us to be in because the city wants the extra advantage of the enticements. The small businesses, many of them join together to say, "Yes, let's do it; even

though it might hurt our business, we think the extra folks coming into town to take advantage of a big Wall-Mart center is going to help us in the end."

I mean we are kind of caught in between here of knowing how to stimulate more activity to produce jobs but yet not hurt people like yourself in the process. Do you have any suggestions in hindsight as to how that could have been handled in a way that would have been more balanced?

Mr. JENSEN. Oh, yes, I do.

Mr. POSHARD. Well, share that with me then.

Mr. JENSEN. First of all, I want to talk about something you talked about. This is something that is coming in the community, and I am very worried about it. It is called the TIF Program. You called it the Tax Increment Financing.

Mr. POSHARD. Right.

Mr. JENSEN. There was a town in Iowa that was hurt very bad by that, called Adel, Iowa. You hear all these wonderful glowing reports about how wonderful things are, but sometimes when they go bad they go real bad. This town got hurt horribly because of a TIF Program.

My recommendation for this basically is good old fashioned due process, notification, and an opportunity to comment. All those people who had eyes on that project all had dollar signs in their eyes. First of all, the bank, they will get a loan on it. You guarantee for the loan there; hey, they'll make any loan. The certified development company, they make a half percent per year on the loan balance, so they are making money on it. The developer there, he sees a chance to make a development with only 10 percent down. If it works, great; if it doesn't, hey, forget it. There are other people too that can make from these loans.

If you have a simple notification—and I cannot understand why a Government entity would not let people know that it is helping to finance a community betterment project. Let the community know about a community betterment project. I don't think that is too unreasonable. Then everybody would have had an opportunity to comment about it, including people who had their jobs lost because of the new motel and people who would also have other property at risk too.

Mr. POSHARD. Now generally where I live, when these economic development tools are offered to prospective business and industry, it is always in the paper. I mean generally everybody knows that this potential for development is ongoing and so on. Did you not know anything about that? I mean you discovered that a potential competitor was being helped later down the road after it was all over? I mean you are saying you should have had notice that that was going to be done.

Mr. JENSEN. Right. It's kind of ironic how I discovered it. I was experiencing financial problems, so I called the SBA in Ottumwa, Iowa, and the director over there said, "I think we might have worked with that Super 8 there," and he sent me some clippings on it, and luckily I know something about the Freedom of Information Act so I did some nosing around, and that is how I found out that SBA was involved in this program. It wasn't until then that

I knew what was going on. Once I found out what was going on, then I started putting the pieces together.

Mr. POSHARD. Well, Madam Chairman, as you know, I'm a strong supporter of the SBA Program. I think it has done marvelous work, but maybe this is something we ought to consider in terms of a balance. Maybe folks aren't being notified and there is a potential for being hurt by some of this. Maybe it would be fair too to notify with public notices or whatever. I don't know. It is certainly something to take into consideration.

Chairwoman MEYERS. It is something that is of concern to me, I'm sure as well as to the whole committee. You have to then be concerned about whether this would be a discriminatory thing because you wouldn't be giving particularly maybe notice and opportunity to comment beyond the zoning perhaps if this person had no Government money in it, but if he has Government money in it, you are saying then all competitors should be notified and given an opportunity to comment. So, it is a very tough question. I certainly understand what you are saying, and you have brought us a very interesting perspective, Mr. Jensen.

Let's see. Mr. Manzullo.

Mr. MANZULLO. Thank you very much. I appreciate your all coming here.

I guess I'll ask this question to anybody who knows the answer. How are CDC's funded?

Mr. LUECKENOTTE. How are the CDC's funded?

Mr. MANZULLO. Right.

Mr. LUECKENOTTE. The CDC's take a variety of forms, most of them being not for profit. I think throughout the country there are eight CDC's that were originated in the late 60's, early 70's, and are for profit but also deliver the 504 Program. For the most part, we are not for profit.

My particular CDC was actually formed in the 1960's as a 501(c)(3) to assist employment and training needs of migrant and seasonal farm workers throughout the State of Missouri. In the late seventies and early eighties we began assisting other businesses through the Job Training Program funded through the State, and this program—the 503 Program was legislated in 1980, and we shortly thereafter applied for certification and became certified in 1983.

Through this program, when a 504 loan is actually funded, which means the 504 loan is not funded until after the project is completed, the business is in operation, the bank has provided the interim financing, we end up at that point taking the bank out. At that point in time, the certified development company receives 1.5 percent of the 504 loan amount as a processing fee.

Mr. MANZULLO. So the question really is apparently you are self-funded.

Mr. LUECKENOTTE. Yes, that is correct.

Mr. MANZULLO. The 57 cents that comes for every $100—you receive none of that?

Mr. LUECKENOTTE. That is correct. The 57 cents goes strictly to cover the losses in the program. Our fees are actually paid by that small business person that we are providing the financing to.

Mr. MANZULLO. Ms. Kelly had a question trying to find out the actual cost of this program. Ms. Ryan, do you know how many employees at the SBA are involved in the 504 Program?

Ms. RYAN. We know how many employees are involved in the headquarters exactly, and then what I need to do to give you a good answer is to do some proportionate share of 504 work versus 7(a) work, because it is the same work force out in the country that handles both sets of loans.

Mr. MANZULLO. How many employees are there?

Ms. RYAN. The total agency is about 3,600 employees, and——

Mr. MANZULLO. That doesn't include the emergency——

Ms. RYAN. That is correct.

Mr. MANZULLO. Those assigned to FEMA, which is about 4,000, an additional 4,000.

Ms. RYAN. At the very highest levels during major disasters it has gotten up that high, but those are temporaries for the most part. There are about 300 people who work in the agency on a permanent basis that are on the loan processing side, and then about 600 to 700 that are in the loan servicing, loan liquidation, side.

Mr. MANZULLO. So the figure of what this program costs the Federal Government then would be substantial more than 57 cents because that doesn't factor any of the overhead in administering it. Is that correct?

Ms. RYAN. That is correct, although I don't think it wouldn't be much more than that

Mr. MANZULLO. But we are talking several hundred employees.

Ms. RYAN. But what I am trying to say is, this is a small program in SBA's overall work load, and the way the SBA works in the field offices where the loans are originated, the bulk of the work done by those folks is the processing of the SBA 7(a) loan guarantees as well as on the loan servicing side.

Mr. MANZULLO. Let me ask a further question then. Perhaps Mr. Kehoe could answer this question.

I came in during your testimony. I was tied up in an International Relations Committee meeting. Had you applied for conventional financing and been turned down prior to your working with the SBA and the 504 to buy your Ford dealership?

Mr. KEHOE. I didn't use the 504 Program to buy the Ford dealership, I used it to purchase the previous company that I owned that is still in existence, but yes, I had been to several banks that were very not interested in hearing what I had to say or about what we could or could not do.

Mr. MANZULLO. Thank you.

Chairwoman MEYERS. Thank you very much, Mr. Manzullo.

Ms. McCarthy.

Ms. MCCARTHY. Thank you, Madam Chairman, very much.

I would like to follow up with Ms. Ryan on the issue of the John Jensen incident. Are there others like this? Do you in your agency compile statistics of whether, where you come into an area, provide these loans and a similar business goes under?

Ms. RYAN. No, we don't compile such statistics, and as the chairwoman said, it is a very complicated issue because I'm sure in the history of SBA there have been other situations where we have financed a business and they have done very well and some other

business can argue that that business' competitiveness hurt that company, but that is not something that we have any way of tracking. The best assurance in our free enterprise economy is to look very carefully at the deal on the front end because it is the newcomer who really has the onus on them to prove there is a market.

Ms. McCARTHY. Let me try it another way. In this incident, as I understand it, the SBA helped a national chain come in and build a competing structure. Is the program we are discussing today—how many times do you help national chains? I heard a lot of success stories here today of the kind of programs I think you should be helping, but I was kind of wide eyed to hear of your helping a national chain.

Ms. RYAN. A lot of what we think of as national chains operate as local franchises. For a lot of small business people the only way that they are going to get a shot in business is through franchise ownership because the franchise provides a lot of training and helps the people quite a bit. They may not have a strong business background, so it is a really good way for a lot of people to go into business through owning a franchise. When they say it is Super 8, it may have the Super 8 marketing materials and some support, but it is a locally owned business. Again, I don't know the facts of this particular case.

Ms. McCARTHY. I honestly don't know enough about what that national chain such as a Super 8 or a McDonalds does in its own way to make sure that the local person has the ability to get a loan and carry on the business, but I would suspect that that is an issue that you might want to revisit in your agency, because I don't think the national tax dollars were meant to help a national chain compete against a local mom and pop, and that is what this setting says to me, and, again, I don't have all the statistics nor do you, but it is a policy issue that probably ought to be reflected on. If it is a good idea for a McDonalds or a Super 8 to come in, then it is a good idea for them to come in, but using Federal dollars to compete against a mom and pop that is already there is a policy question that needs exploration.

I have watched as a member of State government the use of tax tools to help development. I have watched Missouri cities, main streets, empty, hardware stores closed, little mom-and-pop shops up and down, the dry cleaners, whatever.

Now Jefferson City, a case in point, because we use tax incentives, Federal and State, to help a big mall or a big Wall-Mart or whatever build outside of town. Now in the State of Missouri we have what is called a Main Street Program to try to use tax tools to bring people back downtown. Just once if the Federal Government would stop and reflect, in partnership with State governments, on what we are doing here with these tax tools, I, as a former tax chairman, would be most grateful, and I am really pleased, Madam Chairman, for the opportunity of this committee to explore these policy questions and try to do what is right for everyone. I am very grateful. Thank you.

Chairwoman MEYERS. Thank you, Ms. McCarthy, and I think it is good to look at all sides of the question. I have been a strong supporter of the 504 Program just because I think that frequently people who are able to expand their businesses have a hard time

getting long-term lending for this type of expansion, and yet I think it is good that we hear all sides.

I would like to ask a question of Mr. Lueckenotte, and maybe others can help shed some light on this.

Typically, how do your customers come to you? How do the clients come to you? How do they know about you? Do they make a call to the bank and the bank says call the CDC? Do they talk to the Economic Development Commission? How do they find out and find their way to your door?

Mr. LUECKENOTTE. CDC's do a number of things to make the general public aware of the program and give them access to it, including marketing tools such as going door to door to banks to inform them of the program, press releases to the local communities, success stories in the newspapers to inform the local people about the program, presentations at banking groups, in front of realtor groups, just a variety of ways to market the program.

How do the businesses find us? A lot of the referrals that we receive come from a bank. The business person goes into a bank looking for financing for his project, and the banker says, "I'm sorry, but we don't do that type of financing without some type of assistance," and at that point the bank calls us to see if we are interested in doing that type of a project, and at that point we start looking at it. Other times, businesses call us direct.

We have a pretty good network in our State with the local economic development people through the Chambers of Commerce, through the Economic Development Districts, and most of those people are also familiar with the 504 Program, so when businesses are looking to develop in their communities they also inform them of the 504 Program and the options that are available. So, it is just a variety of ways.

Chairwoman MEYERS. One concern that I have had about the 504 Program is that I think maybe, I'm not sure whether it is in the law or not, that you can't take into account the amount of assets the person has, but it has always seemed to me that common sense would dictate that with limited dollars perhaps that are available the money would go to those who have a greater need. But how do you determine? When you get an opportunity to make a loan and you know this person has a tremendous number of assets personally, how do you determine?

Mr. LUECKENOTTE. Well, we have a size standard. The business and their affiliates cannot exceed a net worth of $6 million. That does not preclude an individual that has a net worth in excess of that from receiving assistance from this program. However, we look at that very closely to see what their assets are, whether their book value—many times we will see a financial statement of an individual at $5 or $6 million. However, $2 or $3 million of that may be blue sky; when you look at where they really arrive at that value, it is not there.

Chairwoman MEYERS. And so you are saying that—is it in the law that their business and their affiliate businesses can't have a value of more than $6 million but their personal wealth can be unlimited?

Mr. LUECKENOTTE. Provided their personal wealth is not in stocks and ownership of companies that attribute to that large net

worth. If, for example, they would have an apartment building that from a book value may have, for example, a value of $2 million but they believe it has a value of $10 million, they would put that on the financial statement at $10 million. In reality, it is not worth that much. In that particular case we would look at the actual book value of that business and determine that it is $2 million and not $10 million. If we have someone that comes in and shows $10 million cash on his personal financial statement, we would not make that individual a 504 loan simply because he has the resources to finance that business without Government assistance.

Chairwoman MEYERS. OK.

The reason I kind of zero in on this is because with limited dollars we are going to have to look at the parameters on every program that we have, and I would like to direct this question to Mr. Donaldson. I think the criticism of those who criticize the SBA—and we do have our critics; I happen to be a supporter, but there are those who do criticize—they say the 504 is really unnecessary because what we are talking about here is loans made to people where there is collateral, this is bricks and mortar lending, and so it is really Government in a program where it doesn't really need to be, and that there should be private financing, the banks should be willing to make these kinds of loans because there is collateral involved.

Now I know there is an answer to that, and so I'll ask you for it.

Mr. DONALDSON. Certain types of commercial real estate are more marketable than others. When you talk about the value of a piece of commercial real estate, its value depends on a number of factors, i.e., the type of building, quality of construction, its location, et cetera. If we took and built a $50 million hotel and put it in the middle of the Sahara Desert, what is it going to be worth? It is not going to be worth anything. If we take and build, for example, a fairly low risk—typically in the banking business the most low risk type of commercial real estate is an office warehouse; motels, bowling alleys, grocery stores are very high risk, very high risk, because if the bank gets it back and then we have to try to convert it to some other use, it is very costly. You can imagine trying to convert a motel into some other use; it would just be impossible.

There are also pollution things that you have to bear in mind. Sometimes manufacturing facilities will produce pollution. If the bank gets that property back, we may be saddled with the cleanup costs.

So the value of an asset is a case by case, and how do we determine what we are going to loan on it? It is a combination of things, it isn't just the value of the real estate because we don't want that real estate back. We want the borrower to pay us back in cash, and so we look very closely at several key factors. Probably the thing that banks look most closely at is the borrower's ability to generate a cash flow to pay our loan back.

Does that answer your question?

Chairwoman MEYERS. Yes, it does. Thank you.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Madam Chair.

I have a number of questions, technical questions, so if we can try and run through them, Ms. Ryan, let me ask first of all, what exactly is the fee structure under this loan? I am not familiar with the program, so that is why I am asking this. I know that the CDC has it sounds like a 1½ point origination fee. Is there an additional fee structure that is charged from the SBA standpoint?

Ms. RYAN. Yes, and I'll do my best off of my memory, but so I don't make an error I'll give you the exact answer for the record following this.

Mr. BENTSEN. Sure.

Ms. RYAN. But basically there is an origination fee that the CDC gets; there is a guaranty fee that SBA gets.

Mr. BENTSEN. Is that an annual fee?

Ms. RYAN. No.

Mr. BENTSEN. Just up front?

Ms. RYAN. In the initial transaction, and then there are some other small up front fees that go to the other sort of parties in the beginning.

Mr. BENTSEN. Pass-through costs for legal and title and things like that.

Ms. RYAN. Then on an ongoing basis over the life of the loan the CDC gets a small percent of the annual outstanding balance of each part of the loan.

Mr. BENTSEN. Like an annual guaranty fee or what you would have in a letter of credit or something like that.

Ms. RYAN. Something like that, but it is just a small fee. But that is an important fee to the CDC's because it gives them an income stream that pays for them to service the loans.

Mr. BENTSEN. Sure. But there is no annual guaranty fee for the SBA, it is just a one-time fee.

Ms. RYAN. It is just a one-time.

Mr. BENTSEN. The loan-to-value ratio is 90 percent——

Ms. RYAN. It is the typical structure under 504; 50 percent bank, 40 percent from the 504 loan, and then 10 percent equity.

Mr. BENTSEN. Less origination or whatever.

Ms. RYAN. Well, that's added on top.

Mr. BENTSEN. Yes. The loan loss rates—that nine-tenths of a percent, that is historical.

Ms. RYAN. Yes.

Mr. BENTSEN. That is net of recovery?

Ms. RYAN. Correct.

Mr. BENTSEN. What is the success of recovery?

Ms. RYAN. About 80 percent of the loans that go into liquidation.

Mr. BENTSEN. And that amount is also net of the lag time, and that includes the lag time on recovery, whether it is 18 months, 24 months, or whatever, and the interest cost during that time.

Is there a rate differential between the commercial loan and the 40 percent second tier?

Ms. RYAN. Generally there is, and it depends on the market at the time when the loan is made how big the rate differential is, but usually the 504 loan is a point to two points lower than the bank——

Mr. BENTSEN. Than the bank loan.

Ms. RYAN. Right, and one of the things that the SBA requires of the bank is that it at least go half as long in terms of the maturity. We are trying to push the banks with this program to make a little bit longer-term loan than they might otherwise make.

Mr. BENTSEN. Mr. Donaldson, step in here—well, that brings up another question too. Assuming you are trying to do a 20-year note, the bank may not go the full 20 years and you will structure it in trying to do a level amortization or something to take it out 20 years with the bank maybe only going 10 years. Is the bank on a floating rate, or is it a fixed rate as well?

Ms. RYAN. The banks could be on a fixed rate, but that is a little unusual, they generally are on variable rate. That often depends, again, on market conditions. The 20-year debenture with the 10-year bank term is the typical structure, and then usually if the bank has a fixed interest rate it might be fixed for a shorter period of years and then they would have a rate adjustment.

Mr. BENTSEN. I'm rushing through because I have a number of questions I want to go through.

On the budget scoring aspect of this—and I don't know what the total portfolio is of loans for outstanding, but is it $10 billion, or how many—well, you can get me that.

Let me ask you this. On the budget scoring as these loans are amortized and are paid back, and presumably they are paid—if everything goes accordingly, 50 percent goes to the bank note, 40 percent goes to the guaranteed note, you in turn pay back the debenture holders—is that money recycled as you pay back, or does it go back into the treasury?

Ms. RYAN. Not technically. It goes into the Treasury.

Mr. BENTSEN. All right. So, there is no recycling.

Ms. RYAN. Basically the way the program works now, it is not a direct loan program, so the borrower pays the bank itself, and then the 504 payment is paid to the private investor whose funds——

Mr. BENTSEN. There are two sets of documents that they operate under.

Ms. RYAN. Right.

Mr. BENTSEN. I would be interested to find out what the cooperation is like, for the record, with the intergovernmental cooperation I saw that you will try and work with agencies development finance agencies with various States and cities, and I would be interested in seeing what the relationship is there, and I would just say for the record, Madam Chair, I think—and this raises your concern as well. I think this sounds like a very good program, and I think it lends itself to look at ways that it might even become a little more self-financing, playing around with the interest rate differential that is there.

But I think it also raises a question that we may want to look at as to whether or not—because I imagine that the Government part of the loan acts as a back stop to the commercial bank part of the loan which makes the commercial bank loan better than it would normally be and maybe creates a good secondary market for that as well.

But we have to decide whether we are subsidizing rate or providing access to credit, and I think that our first goal is probably to

89-177 O - 95 - 3

provide access to credit and then look to whether or not we want to subsidize rate, which I think raises your concern a little bit in the market economics where somebody has that and somebody else doesn't.

I like the way the program sounds, but I would be interested in seeing us explore ways that we might be able to make it a little more self-financing.

Thank you, Madam Chair.

[The following information was subsequently received from Ms. Ryan:]

Certified Development Company (CDC) status is granted to economic development organizations that are either 1) created expressly for the purpose of delivering the 504 loan program, or 2) existing organizations that sought CDC status in order to deliver the 504 Program in conjunction with complementary programs.

CDC's are the pivotal participants in the delivery of the 504 Program. To be eligible for certification they must be public purpose not-for-profit corporations serving a defined area of operations. CDC's are required to have a membership representative of Government, business, financial institutions and community organizations and have ongoing capability to package, process, close and service fixed asset loans (502 & 504 loans).

A CDC may:

- package 7(a) loans and loans for other Federal and State Agencies
- serve as a microlender intermediary
- work with SBA's women or minority prequalification program
- provide management and technical assistance in conjunction with SBA and other programs
- manage revolving loan funds
- manage small business incubators
- help small concerns access procurement opportunities
- marshall economic development resources

CDC's are a useful "one stop shop" for rural development. Recently, CDC's were given statutory authority to enter into contracts with 7(a) lenders to process and service 7(a) loans.

As of December 14, 1994, there were 283 CDC's.

The Associate Development Comp[any (ADC) designation was created as a means of providing increased access to the 504 Program for businesses located in areas with inactive CDC's. The ADC designation provides organizations that would not or could not deliver the program effectively with recognition and a means of marketing the program. An ADC must establish a relationship with a CDC who provides the processing and servicing support if it wants to be a conduit for the 504 Program.

The fee structure for the 504 Program is as follows:

To the Certified Development Company:

- 1½ percent origination fee,
- ½ to 2 percent (annual rate) servicing fee paid monthly on the outstanding balance (determined at 5 year anniversary date).

To the SBA and others to cover administrative costs of the program:

- Central Servicing Agent (CSA) servicing fee of 1/10 percent (annual rate) paid monthly on outstanding balance (determined at 5 year anniversary date),
- Underwriters fee of 5/8 percent,
- Reserve Deposit of ½ percent to SBA,
- Funding fee of ¼ percent.

Chairwoman MEYERS. Thank you for your good questions, Mr. Bentsen, and we do have two votes. I think the first is on the previous question. The next one is on the rule.

Mr. Flake, why don't you take a couple of minutes and then we will adjourn; and, Mr. Luther, could I ask you, if you have questions, could you submit them in writing.

Mr. LUTHER. Sure.

[The questions and answers may be found in the appendix.]

Chairwoman MEYERS. All right. Mr. Flake.

Mr. FLAKE. Thank you very much, Madam Chairlady.

This hearing is both interesting and important. I just finished testifying over on the Senate side. One of the concerns that I raised was how do we get more money into communities here in America? How do we rebuild the infrastructure particularly of those communities, whether rural or urban, that make up the essence of a Third World country within our own borders?

I think the 504 Program actually gives us the possibility of doing much of what I am arguing for. It does not go far enough, quite frankly. One of my great concerns has been how do you develop a securitizing mechanism that is similar to the other GSE's we have with Fannie Mae and Freddie Mac.

I'm a community developer. I have eight corporations under a Church umbrella, and, we have done about $30 million worth of projects.

I think the 504 guaranty gives us a good opportunity to rebuild many of these commercial strips that are deteriorating in a lot of communities around this Nation. The fact that you use nonprofit CDC's is a major plus, because it means that you are dealing with people who have a direct investment and interest in those communities in which they serve.

So I would argue, Madam Chairman, that this is one of the kind of programs that you hear me consistently asking us to look closely at when we talk about lowering the amount of money we put into programs that we traditionally call social. As we make arguments for what we need to do to solve our Mexican problems or problems anywhere else in the world, we have to look at our own country and begin a stabilization process here. I think 504 provides us this opportunity, and I would hope that those persons on this committee will give great emphasis to assuring that a significant portion of these 504 loans go into those communities that have been least served. I started with myself and a secretary. I went to 30 banks who wouldn't loan us money, and the reality is that is too prevalent.

I commend you for what you are doing, but I ask you to work with us so that we can convince people, that this is the way we have to go for the future.

I am not opposed to taking people off of welfare. I don't have a fight with it as long as we create a means to generate jobs in the community where those people live. If they have jobs in those communities, I am a witness, then they will work. You just have to create the jobs and make it possible.

So I solicit any reaction you may have. I don't have specific questions. I preach a gospel of social and economic development, so that is where I am.

Chairwoman MEYERS. Thank you very much, Mr. Flake.

I would like permission for all members to have an opportunity to submit opening statements for the record. Without objection, that will be done. I appreciate very much your all being here today. You have contributed to our knowledge and our ability to think about this subject, and thank you very much.

The meeting is adjourned.

[Whereupon, at 11:50 a.m., the committee was adjourned, subject to the call of the chair.]

APPENDIX

Opening Statement

Hon. John J. LaFalce

On

Certified Development Company Program

I am pleased to attend and participate in this hearing on the Certified Development Company or 504 program.

As the author of this program in legislation enacted in 1980, I am always proud to review the development of this program.

The CDC program is one of the finest examples I know of what can occur when the Federal government acts to establish a joint funding program with the private sector.

In a typical CDC funding, a private lender provides a private loan for one-half of the cost of the project being financed. The private lender is completely at risk as there is no Federal guarantee. SBA then steps in and provides another 40% by guaranteeing a debenture or long term loan which is then sold to private investors. The small business being assisted provides the final 10%.

Under this scenario, over 21,000 small businesses have received financing for plant and equipment needs. These firms have used over $16 billion in financing, of which less than $6 billion was guaranteed by the SBA. The result of this funding has been the creation or maintenance of some 350,000 jobs.

Possibly even more important in these austere times is the cost of the program. It has the lowest loss rate of any program I know - - - slightly more than one-half of one percent.

This is a program which clearly works and is an example of the type of loan program which truly benefits the borrower and our economy. It deserves the support of all Members of this Committee and the Congress.

(504hrng.sta)

OPENING STATEMENT
OF
CHAIRWOMAN JAN MEYERS
COMMITTEE ON SMALL BUSINESS
HEARING ON THE 504 LOAN PROGRAM
MARCH 9, 1995

The Committee will come to order,

Today the Committee on Small Business will be hearing testimony regarding the Small Business Administration's Section 504 lending program. Through the 504 program small businesses gain financing for capital improvements - "bricks and mortar" work - through a unique cooperative effort among bankers, non-profit certified development companies and the SBA. This cooperation coupled with a requirement for job creation has made the 504 program a solid tool for economic development.

Over the years the 504 program has required little maintenance. However, last Congress the SBA Reauthorization acted to streamline the 504 loan approval process. Also, the SBA recently decertified a number of CDCs under their Associate Development Company initiative. We look forward to hearing about how these changes have affected the program and whether more needs to be done.

WITNESSES

Our first witness is Ms. Mary Jean Ryan. Ms. Ryan is the Associate Deputy Administrator for Business Development at the Small Business Administration;

Our next witness is Mr. Ken Lueckenotte, Executive Director of Rural Missouri, Inc. , a Certified Development Company in Jefferson City. Mr. Lueckenotte is here representing the National Association of Development Companies;

Our next witness is Mr. Jeffrey Donaldson, Vice-President of Northwest National Bank in Vancouver, WA, a bank with an excellent history of 504 participation;

Our third witness is Ms. Katharine Delahaye Paine of Portsmouth, NH. Ms. Paine is the founder of Delahaye Communications and at this time I would like to introduce into the record a letter from Representative Bill Zeliff welcoming Ms. Paine. Unfortunately, Mr. Zeliff is chairing a hearing at his Government Reform Subcommittee and regrets that he cannot be here as well.

Next is Mr. William Ruettgers of Charlotte, NC. Mr. Ruettgers is President of Southern Cast, a small foundry. Mr. Ruettgers will tell us about his need to use 504 when his original plant was taken to epxand a highway. As an interesting note, Mr. Ruettgers employs a number of formerly homeless persons and I want to commend him for his efforts to alleviate poverty through job creation.

Our next witness is Mr. John Jensen. Mr. Jensen, the former owner of a motel in Iowa, has a different impression of the 504 program and will share his view of some of the serious flaws in the program.

Our final witness is Mr. Michael Kehoe, owner of Kehoe Ford in Jefferson City, Missouri. Mr. Kehoe will discuss his success and expansion into Osage Industries.

STATEMENT OF THE HONORABLE KWEISI MFUME

ON THE SMALL BUSINESS ADMINISTRATION'S

504 DEVELOPMENT COMPANY LOAN PROGRAM

March 9, 1995

Thank you, Madam Chair, for this opportunity to look into the components of the SBA 504 program and hear from people who both administer the program through the Certified Development Companies and have benefitted from the 504 program as small businesses.

From all of the testimony I have had a chance to review, it appears that the SBA 504 program has been a success in fulfilling its mission of providing much-needed, long-term capital to small businesses. Although I have also heard from people who have had bad experiences with the program, the overwhelming majority of the people who have come in contact with the 504 program have positive things to say.

As we are all aware, one of the most daunting tasks for the vast majority of small businesses is to come up with enough capital to keep their businesses afloat and expand. This is especially true of minority- and women-owned businesses, as I believe Ms. Payne will testify. For this reason, I consider the $8 million it cost to support this program in fiscal year 1995 a sound investment, especially in light of the $1.434 billion in small business loan proceeds that this amount is expected to generate.

As I understand it, one of the seven public policy goals that were established in the 504 enabling legislation was the expansion of minority business development. I would be interested in knowing to what extent that goal is being met by the 504 program, and if there is any concentrated effort to increase participation in the 504 program by women and minorities.

As Ms. Payne states in her testimony, she found it harder to obtain the loans she needed to expand her business because of her gender. I am certain we could bring several minority business people here to testify to the same thing. It therefore makes sense that some portion of this programs energies be spent on reaching out to this underserved population.

Thank you again Madam Chair for this hearing, as well as the others which are providing us the opportunity to take in-depth looks at the various SBA programs.

Committee on Small Business
The House of Representatives

Opening Remarks
of
The Honorable Glenn Poshard

March 9, 1995

Madam Chairwoman, I again want to thank you for holding these important hearings examining the Small Business Administration. I hope when these hearings conclude, my fellow colleagues on this Committee will have a greater understanding of the importance of the SBA's many programs and their role in providing a prosperous future for America's small business community and our entire nation.

I want to thank today's panel for joining us this morning, and especially for sharing with the Committee their testimony on the SBA 504 Loan Program. I believe the 504 program is an important part of the SBA, because it provides small businesses with the opportunity to expand and grow through permanent fixed rate financing.

Because I see the opportunities this program provides small businesses, I look forward to all of your comments and recommendations today on how this program is currently working, but more importantly, how it can work better for future participants.

WILLIAM H. ZELIFF, JR.
1ST DISTRICT, NEW HAMPSHIRE

1210 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON D C 20515-2901
(202) 225-5456

DISTRICT OFFICES
340 COMMERCIAL STREET
MANCHESTER, NH 03101
(603) 669-6330

601 SPAULDING TURNPIKE
SUITE 28
PORTSMOUTH NH 03801
(603) 433-1601

TOLL FREE IN NEW HAMPSHIRE
1-800-649-7290

Congress of the United States
House of Representatives
Washington, DC 20515-2901

DEPUTY MAJORITY WHIP

CHAIRMAN
SMALL BUSINESS SURVIVAL CAUCUS

COMMITTEE ON
GOVERNMENT REFORM AND OVERSIGHT
CHAIRMAN
NATIONAL SECURITY INTERNATIONAL
AFFAIRS AND CRIMINAL
JUSTICE SUBCOMMITTEE

COMMITTEE ON
TRANSPORTATION AND INFRASTRUCTURE
SUBCOMMITTEES
WATER RESOURCES AND THE ENVIRONMENT
SURFACE TRANSPORTATION
AVIATION

March 9, 1995

The Honorable Jan Meyers, Chair
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515

Dear Chairperson Meyers:

I sincerely regret that I cannot be at the Small Business Committee's hearing this morning to review the SBA 504 program. My responsibilities as Chairman of the National Security, International Affairs and Criminal Justice Subcommittee demand my presence at a hearing on our nation's drug policy that is also taking place this morning.

During your proceedings today you will have an opportunity to hear from Katherine Paine, founder and CEO of The Delahaye Group, Inc., an international marketing communications research and consulting firm. I am proud to tell you that The Delahaye Group is located in Portsmouth, New Hampshire, and therefore, within the Congressional District I represent in Congress.

When you hear Katie Paine's story, I know you will be impressed not only with the success she and her company have achieved, but also the entrepreneurial spirit she exemplifies. It is exactly this kind of spirit that needs to be fostered and supported within the small business community in this country.

Please convey my apologies for my absence to Katie. I look forward to reviewing her recorded remarks.

Sincerely,

Bill Zeliff

Bill Zeliff
Member Of Congress

NORTHWEST NATIONAL BANK

A. Jeffrey Donaldson

Vice President

Northwest National Bank

Vancouver, Washington

TESTIMONY

U. S. HOUSE OF REPRESENTATIVES

Committee on Small Business

March 9, 1995

Thank you for the opportunity to testify and publicly comment on your Committee's hearings on the SBA loan guaranty programs. My comments will address only the SBA 504 program, as my lending experience in this area is greater than for other SBA programs.

My experience in commercial bank lending to the business community spans twenty years; doing both bank conventional commercial loans of all kinds (i.e. lines of credit, short and long term loans, commercial real estate loans, letters of credit transactions, etc.) and SBA loan programs of various kinds. My position is that of Vice President doing commercial lending to small businesses throughout Southwest Washington state. My employer is Northwest National Bank, located in Vancouver, Washington.

Vancouver is Clark County's largest city with a population of about 50,000. The county's population is approximately 250,000. Northwest National Bank is a privately owned national bank with ten branches, all of which are in Clark County. The bank has deposits of about $250 million and loans of about $180 million. The bank's primary market niche is the local business community. It also provides substantial lending to individuals, government agencies, and other organizations for a variety of worthwhile purposes.

I have been involved in a number of SBA 504 loan transactions over the past four years. Based on these experiences, and my non-SBA conventional lending experience, I can shed some light on the 504 program and the value of the program to small businesses.

Many small growing businesses that are normally classified as "high risk" by commercial banks feel ignored when requesting long term credit. The SBA 504 program solves this problem by providing a source of long term credit, and at a low cost to boot -- lower than can be obtained through conventional bank loans.

<u>504 Basics:</u>

Congress created the 504 program in 1986 to assist only small business owner-operators. The program provides loans to <u>successful</u> growing businesses for fixed asset expansion, including the following:

1. Purchase of land and construct a new building (all hard and soft costs can be financed).
2. Purchase an existing building and make necessary renovations.
3. Make leasehold improvements on leased property.
4. Acquire and install machinery and equipment with a minimum ten-year economic life.

Most projects must either create or save one job for every $35,000 of 504 financing.

Credit Structure:

A typical 504 project looks like this:

1. Bank provides at least 50% of project's cost.
2. SBA guarantees debentures that provide up to 40% of the project cost.
3. The borrower must contribute at least 10% in additional equity.

504 financing is available in ten or twenty-year maturities. Real estate is usually financed for twenty years. The maximum SBA portion funded through the SBA guaranteed debentures can be as high as $1 million. The practical minimum loan is $75,000.

Advantages to Lenders:

- It allows banks to fund capital expansion projects of successful growing small businesses that isn't always easy. Financing commercial real state carries a much higher risk than residential lending. Bank regulators are very aware of this fact, and continue to criticize commercial banks that pursue these types of loans. The 504 reduces risk on commercial loans to acceptable levels. This is especially important for small banks with low lending limits. Therefore, the bank can gain profitable, lower risk assets.
- 504 SBA loans are suggested in the guidelines of the Community Re-investment Act as a way for banks to demonstrate compliance with that law and involvement in community lending and development.
- There are no fee or interest rate restrictions on the bank's portion of a 504 loan. The bank's interest rate can be fixed or variable, which is a great advantage over other SBA loan programs.
- Unlike the SBA 7(a) program, for which the lender completes all SBA loan package documentation, the 504 package is prepared by the SBA Certified Development Company. This saves the bank a good deal of labor costs.
- Banks can finance more projects than through conventional financing techniques. This enables banks to spread their limited capital among more small business borrowers. This is especially important for small banks.

- Due to the high quality of these loans, they can be sold into the secondary market. This is important to banks that need to create liquidity on their balance sheets.

Advantages to Borrowers:

- Access to 90% financing is often the key to making a project move forward. Many small business owners cannot afford the 25 - 30% down payments required by conventional bank real estate underwriting criteria. High equity contributions can cripple a growing company's liquidity and negatively impact earnings and profitability. In fact, lack of liquidity and capital is one of the highest reasons for small business failures in the country.
- SBA debentures are government guaranteed instruments, so investors will accept low interest rates. This advantage is passed along to the borrower, and results in an overall interest rate that is lower than if the project were funded using 100% bank financing.
- SBA will allow the property to be purchased by an individual owner and leased back to the small business corporation. The can be a real incentive for the owner to build or buy a new facility.
- Access to long term fixed rate financing on at least the SBA portion reduces the monthly loan payments for the small business.
- 504 loans can be assumed by a new business purchaser.
- Availability of personal resources of the owner of the business doesn't disqualify a project for 504 financing, as with other programs.

Why the SBA 504 Program Should be Continued:

- Without the 504 loan guaranty program, many commercial lenders will not be able to provide long term commercial real estate loans to healthy, expanding small businesses that are often viewed as "high risk.". Commercial banks recognize the importance of lending to these types of customers. However, the real risk associated with commercial real estate loans, coupled with the fact that bank regulators are quick to criticize this type of lending (in their desire to prevent another savings & loan-like disaster) causes many banks to avoid small business lending. These attitudes lead to very restrictive lending policies, and, in turn, hold back business growth in our communities.

- The majority of bank deposits, such as checking, savings accounts, and certificates of deposits, carry relatively short term maturities. Stated another way: banks cannot assume that these deposits will stay at the bank for long periods of time. This poses a potentially high risk to a bank when we try to make long term loans using these short term deposits. Bankers therefore must try to match up (i.e. maintain a balance) short term loans and short term deposits. Frequently, only long term deposits will be used to fund long term loans, which is made very difficult in a rapidly changing economic climate, with long term interest rates fluctuating.

  However, due to the fact that 504 loans are very high quality bank assets, they can be sold to other banks via an outright sale on the secondary market, or a part of the loan can be shared with another bank (a participation loan). This funding flexibility allows small banks like Northwest National Bank to make more long term 504 loans because we have the ability to generate liquidity (short term cash assets) should the need arise.

- Loans to "owner users" are lower risk types of loans in bank loan portfolios. We need to promote loans of this kind, not restrict them.

- Without an ability to support development of commercial buildings, economic growth within our local community will be suppressed, job creation will fall, and ambitious, energetic entrepreneurs will be prevented from becoming modern, efficient, and competitive in an increasingly competitive world economy.

Success of the 504 program can be easily demonstrated through an example of the 504 program in action:

> Ron Burback's traveling amusement business, Funtastic Rides Company, is one of the six largest amusement companies in the country. It requires plenty of space for repairs and storage of its heavy equipment. Company headquarters, together with storage, repair, and maintenance space, was on rented property. The lease was about to expire, and would not be renewed by the land owner. After searching unsuccessfully for two years for a suitable alternative site to buy or rent, it became apparent than Ron's only solution was to buy land and build his own facility.

The $2-plus million project would have required that Ron put up at least $700,000 as new equity in order to obtain conventional bank financing. Ron couldn't put in that much cash without crippling his ability to operate his company. He needed the cash for on-going operating expenses.

However, the 504 program offered a solution to his predicament. Once he was approved for a 504 loan, he was able to contribute a total of $375,000 of his own cash. The 504 became the enabling force that allowed Ron's project to become a reality. Ron has a stable business with strong cash flow. However, depleting almost his entire cash assets as a down payment for a conventional bank loan would have placed his business in real jeopardy. 504 saved him from having to raise almost $400,000 in additional down payment cash.

Since moving into his new facility in 1993, Ron's sales have increased by 15% and full time employment has increased by thirty people. Ron also employs about 7,000 seasonal employees in communities around the country. If he had not been able to put this project financing together, it would have caused him to default on many fairs, celebrations, and festivals. This would have permanently damaged his business, and put at least 3,500 part time employees out of work. The long term damage to his business would have been tremendous.

In summary, the SBA 504 program enables my bank to provide long term, fixed rate financing to growing small businesses. I don't believe we would be making these loans without this program, due to the high risk. I urge your Committee to continue this loan program in order to maintain a source of long term capital for thousands of small businesses across the country. Thank you for your time. I would be pleased to answer any questions the Members have.

TESTIMONY OF
JOHN JENSEN
U.S. CONGRESS
SMALL BUSINESS COMMITTEE

MARCH 8, 1995

Chairwoman Meyers, Members of the Committee,

I was financially ruined because of the SBA 504 program. My story is as follows:

In May of 1989 I purchased a motel in Centerville, Iowa called the Motel 60 and Villa. I had invested a lot of money in it and put up my farm as collateral for a loan. I was making improvements on it and business was fine till December of 1989 when a Super 8 motel announced that it was going to be built. They opened in May, 1990 and by September 1991 I was wiped out. I lost everything, my money, property, another business and my reputation as a good businessman. I am still in debt.

How did it all happened? Before I purchased Motel 60, I analyzed what I thought would be the probability of another motel coming to town because I knew that the effect on me would be devastating. My line of reasoning was that a new motel would cost about $750,000 and a bank would want at least 20% down payment. That would be around $150,000. My thinking was that if someone had that much money to invest, there would be better places to invest in than Centerville, Iowa. I felt pretty safe.

Under the 504 program a Super 8 motel was called a "job creation project or a community betterment project" and the developer only had to come up with 10%. That was only $75,000, a small amount in the motel business. If I would have known that my competition could come in and build for 10% down and have the Federal Government back him, I would have never invested in the lodging business.

I have a problem with the way my competition received the loan. He called it a community betterment project and under the rules, he needed "Written documentation demonstrating significant impact." This consisted of six letters from people who had a vested interest in a new motel. For example- The utility company which would sell more power to new business, and the newspaper which could sell more advertising space. Not one of the people who wrote these letters could be qualified, in any way, to judge on the need for more lodging in Centerville. All they had were opinions when I could have provided the facts.

I am not the only person who has been ruined by this program. There have been other motels built in the Iowa towns of Lemars, Independence, Perry, Sioux Center, Dyersville and Harlan. I have no problem with the one built in Harlan, because it was the only one built to replace a hotel that was torn down. I have talked with hotel owners in Perry and Dyersville and they have also been hurt by these projects. This is just in Iowa, but I wonder how many other businesses have been hurt nationwide?

These people are receiving Federal Assistance under false pretenses. They say that they are "creating jobs" but in reality they are only transferring jobs from one motel to another. In their wake they leave owners in financial ruin. It has to be stopped now! Who speaks for the honest small businessman who is taking risks without SBA's help?

Thank you for the opportunity to testify before you. I don't mean to attack anyone, but someone, somewhere down the line, needs to think about how this "job creation" program is working. I know it isn't working out in Iowa.

TESTIMONY BEFORE

COMMITTEE ON SMALL BUSINESS

U. S. HOUSE OF REPRESENTATIVES

Mike Kehoe

President & C.E.O.

Mike Kehoe Ford, Lincoln/Mercury, Jeep/Eagle, Inc.

Jefferson City, Missouri

MARCH 9, 1995

In today's competitive business environment, it takes many things to make your business successful. You have to have good products, a commitment to customer satisfaction, top notch personnel, a strong business plan, and adequate financing. Putting all of these items together is rare. Trying to do it when you're young with little experience is next to impossible. I received a SBA 504 loan and a SBA 7A loan guarantee totalling almost half a million dollars when I was 26 years old. If it were not for these programs, many jobs would have been lost, a business vital to a small rural community would have folded, and an annual payroll/tax base of over one million dollars would have been non-existent.

I started my business career working as a lot "porter" for a Ford new car dealership in St. Louis, Missouri, at the age of 18. After washing cars for a year, I earned the opportunity to move up in the organization and I became a new truck salesperson. I became the top salesperson in the first year, was promoted to assistant Truck manager in two years, and became the Truck manager in just four years. I was the youngest Truck manager for a Ford Motor Company dealership in the United States, and at the age of 25, I was awarded the Truck Manager of the Year for the St. Louis Ford District in 1986.

In 1987, I was asked by a group of Ford dealers to move to Linn, Missouri, to take over a Conversion Van manufacturing company that was experiencing some rough times. This company, known as Osage Vans, had been in business for five years, and although it was a small company, it had become very important to a small community with little employment base. When I took the job, the dealers told me that they felt the company was in bad shape, and would probably just as soon see it closed and cut their losses, rather than prolong the agony. This investment to them had become more of a pain than it was worth. It was February of 1987, Osage Vans had employment of 27 people, and annual sales of $2.5 million. The company was five months into its current year and was showing a year to date loss of almost $200,000.

I knew this picture looked bleak, and the dealers were probably right, the company should be closed. But as I met the people, realized their commitment to build quality products, and saw how important the job was to them, I knew somehow we could make it. With the hard work and dedication of these people, we increased production 50% and turned the loss into a profit in just seven months. I knew I had a winner, but the owners still did not want to be bothered. I was also being contacted by Ford Motor Company to run one of

their dealerships for them. It was decision time. I decided that I could make this company a success if the owners would agree to sell. I had very little money at the time, but I figured I would be able to arrange financing to put the deal together. The owners agreed to sell, but what it took to put the deal together, is another story.

My accountant and I visited all of the local banks with a sound business plan, and a positive attitude. We were shown the door very quickly. Before we gave up hope, we visited the Missouri Department of Economic Development. They understood that if we did not put a deal together, the company would be shut down and the small 1200 person town of Linn, Missouri would lose a major base of employment. The Economic Development people directed us to Rural Missouri Incorporated (RMI), a Certified Development Company. RMI would help us in working with the SBA, which in turn would give the banks something new to consider.

After RMI toured the plant and met with me to explain the 504 Program, they were convinced that the business would succeed with adequate financing. Since I had little cash to invest, the financing structure was not a typical one. RMI invited John Blum of the St. Louis SBA office to see the business and meet with me to listen to my ideas to make the company a success. John explained that the 504 and 7A programs could help us obtain the necessary financing. Within weeks the same banks who had turned a deaf ear began to listen. On May 8, 1988, we closed the deal with the owners to buy the assets of Osage Vans. I had a $250,000 504 loan, and a $200,000 7A working capital loan, and the help of a local bank who believed in me.

A new corporation was formed called Osage Industries, Inc. The team of managers I had formed were ready to go. A new spirit was evident in the company. The people who worked there finally felt comfortable with their futures as well as the company's. At the time, the company was producing 35 conversion vans, and four ambulances a month. Total employment was approximately 30 people.

In the years ahead, Osage Industries, Inc. grew into a major Central Missouri manufacturer. Production increased to 100 conversion vans and 10 ambulances a month. The product distribution went from the central United States, to all of the United States, Canada and Mexico. An additional subsidiary company was formed, and employment grew to over 100 people. Annual payroll rose to well over 1.5 million dollars and sales toppled the 6

million dollar mark. In 1991, I received the "Young Entrepreneur of the Year" award from the SBA for the State of Missouri, and the central region. Osage Industries has received many awards from Ford Motor Company, General Motors, and Chrysler Corporation for production quality and superior customer satisfaction.

I sold Osage Industries in 1992 to a group of the managers so I could pursue my dream of owning a Ford dealership. The group of managers who bought the company were almost all there from the beginning, and deserved being owners. The company remains very successful today, with 1994 sales of 8 million dollars, and still plays a major role in central Missouri employment.

The dealership I purchased has grown over 25% in sales in just two and a half years. We needed expansion to keep up with the service business that was being generated by the growth in new car and truck sales. We turned again to the SBA in 1994 for help with a real estate loan, that would include expansion of the facility, and room for additional employment. I worked with the 504 program again, and put the real estate deal together. Our employment level here has grown from 85 to 135 people, and the expansion of our facility is what made most of that employment possible.

In this short time I have tried to point out the importance of what the SBA program has done for me and the literally hundreds of Missourians that these programs have affected. I am not sure what the future holds for these programs. What I am sure about is the need for individuals who have the ability if they get a chance. I got that chance. The people we employed got that chance. We made it work. Small Business is what makes America work for yesterday, today, and tomorrow.

Opening Statement of Congressman Patrick J. Kennedy
House Committee on Small Business
Thursday, March 9, 1995

Madam Chair, thank you very much for offering us this opportunity to explore the Small Business Administration's 504 Development Company Loan Program.

This program fills a niche in the loan market which is not met by the private sector. Small businesses need loans for fixed assets, so called "bricks and mortar" loans, but the nature of the market and the expense of servicing loans, prevents the private sector from providing these much-needed loans. The SBA 504 program fills this gap and creates jobs.

By forging a strong public-private partnership, the 504 program has helped over 21,000 small business concerns since 1980. More than 344,000 jobs have been created by these loans. In my own state of Rhode Island, twenty-four loans with a total value of $6.8 million, were made last year alone. Already in the first four months of 1995, seven 504 loans have been made, worth $2.5 million.

In a time when small business is consistently proving to be the engine of growth and job production, assistance such as this which provides crucially needed infusions of capital is more important than ever. If America is going to succeed in the global competitive economy of the twenty-first century, we must ensure that we have we a strong base of small, entrepreneurial firms.

I look forward to hearing today's testimony.

STATEMENT

of the

NATIONAL ASSOCIATION OF DEVELOPMENT COMPANIES

to the

HOUSE COMMITTEE ON SMALL BUSINESS

concerning the

SBA 504 LOAN GUARANTEE PROGRAM

Presented by
KENNETH I. LUECKENOTTE
President, NADCO
Executive Director, RURAL MISSOURI, INC.
on
March 9, 1995

SBA 504: THE MONEY THAT MAKES AMERICA WORK

Good morning, Madame Chairman and members of the Committee. I am Ken Lueckenotte, President of the National Association of Development Companies (NADCO), and Executive Director of Rural Missouri, Inc., an SBA Certified Development Company serving the state of Missouri. I want to thank you for this opportunity to comment on the SBA 504 loan-guarantee program and its ability to efficiently and effectively meet the long-term financing needs of our nation's small businesses.

At a recent hearing of this Committee on the role and mission of the Small Business Administration, Congressman Hefley suggested that, in this time of budget austerity, we need to look very closely at what SBA does to facilitate small business. He indicated that Congress must have the courage to cut wasteful or ineffective business programs. "What does SBA do to facilitate small business?" he asked. "Are there wasteful programs in SBA that should be eliminated?"

We believe that these are legitimate questions that must be addressed as Congress makes the difficult choices necessary to reduce the federal deficit. I would like to take a few minutes in my testimony this morning to examine whether the SBA 504 loan-guarantee program meets the stringent criteria that must be applied to all federal programs as Congress sets spending priorities in the months and years ahead.

Q: What does the SBA 504 program do to facilitate small business?

The SBA 504 program, through more than 300 SBA-Certified Development Companies working in local communities around the country, provides long-term, fixed-rate financing to small businesses ready to expand and create jobs. An SBA-guaranteed 504 loan saved Terry's Onion Rings in rural Kansas from having to close its doors, thereby retaining or creating more than 25 jobs for the 8,000 residents of Edwardsville, Kansas. In Lubbock Texas, the SBA 504 program allowed Rehab Plus Therapeutic Products to expand and create 40 jobs, increasing its work force by 80 percent in one year. J.D. Steward Air Conditioning Inc., in Colorado Springs, grew from 45 to 70 full-time employees with the help of SBA 504 financing. In each case, the 504 program provided the means for qualified small businesses to expand and create jobs in their local communities by offering access to fixed-rate, long-term financing that simply was not available without the assistance of the SBA guarantee. SBA 504 loans are secured by the

real estate, machinery and equipment being financed, are amortized over the life of the loan, and carry terms of 10 and 20 years.

Long-term financing is critical to small-business growth and job creation. The SBA guarantee, in turn, is critical to providing small businesses with access to long-term financing. A December 1994, General Accounting Office report prepared at the request of the House Budget Committee confirms that non-guaranteed commercial loans to small businesses rarely carry terms of more than four years. SBA-guaranteed 504 loans are virtually the only source of affordable, fixed-rate, 20-year financing available to small businesses.

The SBA 504 program targets healthy small businesses that are ready to expand and hire new employees, but cannot find affordable, long-term financing. When these small businesses approach commercial lenders, the best they are offered is variable-rate, short-term loans with balloon payments and minimum down payments of 25 to 35 percent. Small businesses simply cannot afford to tie up operating cash with large down payments and monthly payments that could increase dramatically if interest rates increase. Without the SBA 504 program, these businesses either delay expansion or scale down their plans for growth -- at a cost to society of lost job opportunities, lower tax revenues and less growth for the economy.

The SBA 504 program provides small businesses that are poised for growth access to 20-year, affordable, fixed-rate loans for plant construction or acquisition. Combined with down payments of as little as ten percent, SBA 504 financing allows companies to retain critically needed working capital as they expand. The result is more jobs, higher taxes and faster growth of the American economy.

Without a doubt, the SBA guarantee plays a critical role in providing access to long-term credit for our nation's small businesses. Without such access to affordable long-term financing, small businesses have neither the means nor the incentive to grow. When the small-business sector stagnates, the nation as a whole pays the price. Job opportunities, local and federal tax revenues, and the other, less tangible contributions small business make to their communities are lost in the process.

Q: Is the SBA 504 program a wasteful effort that should be eliminated?

The development-company loan-guarantee program began in 1980 and became known as the "SBA 503 program," after the section of the Small Business Investment Act which authorized its existence. At the time, it was considered revolutionary. Very much aware of the high default rates, low recovery rates and other problems that plagued SBA lending programs through the 1970's, Congress set out to create within SBA a program that would use the incentives and the efficiencies of the commercial-lending community and would leverage greater private-sector participation in small-business lending.

Unlike its predecessors, the 503 program made the loans subject to private-industry underwriting standards by specifying that 50 percent of the financing for each project be financed by a wholly private, non-guaranteed commercial loan. The borrower must provide capital (typically 10 percent) as a down payment, and a debenture issued by a CDC provides the remaining 40 percent. Thus, a private lender has a greater interest than the federal government in each and every project financed by a development-company loan. In the 503 program, debentures were guaranteed by the SBA and funded through the Federal Financing Bank, an agency of the U.S. Treasury.

In late 1986, the development-company program was again revolutionized -- this time in a way that would allow small businesses to tap into the economies of the private-capital market. For years, large businesses had been turning to the private-capital market to meet their financing needs. Dealing in high volume and standardized product, the capital market offered attractive interest rates for long-term financing -- but only in increments of several million dollars at a time. It was, quite simply, way out of the league of the average small business looking for a $300,000 loan to expand into a new manufacturing facility.

Rather than funding loans to small businesses through the Federal Financing Bank, CDC debentures carrying the SBA's guarantee began, in November 1986, to be pooled and sold to private investors. Thus, the "504 program" was born, and named after the newly enacted section of the Small Business Investment Act authorizing the sale of CDC debentures in the private-capital market.

I'm here to report that the revolution was a big success. This year, the SBA will guarantee $1.434 billion in CDC debentures to provide long-term, fixed-asset financing to qualified small-businesses. That SBA-guaranteed financing is conditioned on private

lenders providing more than $2 billion in additional, first-mortgage financing to the small-business projects receiving 504 loans. The total cost to the taxpayers for leveraging more than $3.4 billion in loans to small businesses is just $8 million dollars -- the amount appropriated to cover the calculated subsidy in the program.

Far from being wasteful, every dollar appropriated by the federal government for the 504 program leverages $400 in private capital to fund small-business expansion and job creation. This program is so incredibly cost-effective because its loss rate is so low. The subsidy rate is just 0.57 percent -- by far the lowest of any SBA program. This innovative and unique use of the federal guarantee as an incentive to attract private capital to small business growth and expansion is a model for efficient use of limited federal resources.

Can the SBA 504 program be further "privatized"?

There has been much talk about "privatizing" SBA-guaranteed lending programs as a way to reduce the cost to the federal government. In the most fundamental ways, the SBA 504 program has already been privatized:

- A locally based, private development company certified by SBA packages the 504 loan and evaluates its creditworthiness and qualifications before submitting it to SBA for approval. The CDCs' unique combination of local business knowledge, ability to analyze credit and thorough understanding of SBA lending criteria are evidenced by the very low default rate for the program.

- The SBA guarantee applies to only 40 percent of the total project cost. Fifty percent of the financing package is provided to the small business by a commercial lender without a federal guarantee. Those lenders also apply commercial underwriting standards to the entire project in order to finance their portion of the loan. That lender has a 100 percent interest in ensuring that the small-business venture succeeds.

- The SBA-guaranteed 504 loan is funded in the private-capital market, thereby providing the best rate available to the small business -- short of borrowing directly from the U.S. Treasury. The Wall Street investment firms who underwrite these sales have a vested interest in assuring that the quality of the loans supporting the pools of debentures remains high so that the securities they sell to long-term investors remain stable and attractive.

Q: How can the 504 program do its part to reduce the burden on the federal budget?

The SBA 504 program arguably is today the most efficient of federal programs to assist small business. However, NADCO recognizes the importance of deficit reduction, and is eager to do its part to further reduce costs while continuing to effectively meet small-business long-term financing needs. Toward that end, NADCO and the CDC industry have worked with the SBA on a number of new or pilot programs designed to streamline and reduce the costs of delivery:

- SBA is piloting centralized loan processing and servicing programs in order to gain efficiencies through consolidation of similar functions. Feedback from CDCs indicates that this effort is improving delivery of service to borrowers while reducing the administrative burden at the SBA.

- Another pilot program, the Accredited Lender Program (ALP), is speeding the application and approval process for SBA 504 loans. Modeled after the 7(a) Certified Lender Program, the ALP pilot has demonstrated its effectiveness in the SBA field offices where it has been implemented.

- The Premier Certified Lenders Program, recently authorized by Congress, is expected to further increase program cost-effectiveness by enabling larger CDCs to expedite 504 loan processing and eliminating duplication of tasks by CDCs and SBA.

The SBA 504 program's subsidy rate of 0.57 percent and its annual appropriation level of just $8 million to fund $1.434 billion in small-business loan proceeds are a testament to the program's efficient use of scarce federal resources. In this context, there is not a lot of room for significant reforms or tremendous cost savings. However, NADCO is willing and eager to do its part in responding to Congress' call for savings in all federal programs.

We strongly believe that Congress must continue to fund the SBA 504 program at a level sufficient to meet small businesses' need for the affordable, fixed-rate, long-term financing that will allow them to expand and create jobs. However, we would be happy to discuss with the Committee various approaches to further reducing the program's reliance on annual federal appropriations. One option we would be willing to explore would be to consider the viability establishing a segregated loss reserve for the program,

funded through an assessment of a few basis points built into the interest rate on the borrower's loan. Once again, however, we would point out that the actual impact on the deficit would be minimal, given the efficiencies inherent in the present system.

Q: What will it cost to fund SBA 504 loans to meet the needs of small business in FY 1996?

We anticipate the demand for the program in FY 1996 to be between $1.8 and $2.0 billion -- well within the authorization level approved by this Committee. At the current subsidy rate of 0.57 percent, this level of activity would require an appropriation for FY 1996 of $10 to $11 million. In return for its investment of $11 million, the federal government will be able to leverage more than $4.5 billion in private-sector loans, allowing approximately 6,000 small business to expand and generate more than 57,000 jobs in communities all over the country.

We also are concerned that, if demand for SBA 504 financing continues at its current pace, the FY 1995 appropriation may not be sufficient to meet small businesses' needs. We respectfully request that the Committee consider supplementing the current-year appropriation through reprogramming or other means.

Summary

- The SBA 504 program facilitates small business by providing access to affordable 10- and 20-year financing for expansion and job creation that simply is not available from other sources.

- The SBA 504 program is a model for efficient use of limited federal resources. Every dollar appropriated by the federal government for the 504 program leverages $400 in private capital to fund small-business expansion and job creation.

- The SBA 504 program has been in the forefront of the privatization effort. Loans are packaged by community-based Certified Development Corporations; 50 percent of each project is funded by a wholly private, non-guaranteed commercial loan; 504 debentures are pooled and sold to investors through the private-capital market.

- The SBA 504 program is continually looking for ways to increase efficiencies and reduce costs to the federal government. While the subsidy rate for the program is

already by far the lowest in the SBA, NADCO welcomes the opportunity to work with the Committee and the SBA to implement innovations that will further reduce costs, while maintaining access to affordable long-term financing for qualified small businesses.

- In order to meet the needs of small businesses for affordable long-term financing that will allow them to grow and create jobs, the SBA 504 program will require a federal appropriation of $11 million in FY 1996 . That $11 million will provide for the guarantee of $2 billion in 504 debentures, and will leverage an additional $2.5 billion in wholly private, non-guaranteed commercial loans to small business.

Madame Chairwoman, this concludes my prepared remarks. Thank you for the opportunity to appear before this Committee. I would be pleased to answer any question you and other members may have.

THE DELAHAYE GROUP, INC.

Committee on Small Business
U.S. House of Representatives
Katharine D. Paine
Founder and Chief Executive Officer
The Delahaye Group, Inc.
March 9, 1995

The Delahaye Group really shouldn't exist. Imagine a woman, a former journalist with no business experience starting a company in the midst of a recession, a company that provides a service that no one understood. But thanks to the SBA the company does exist.

The story began eight years ago, I knew that a market existed for a service that would measure the effectiveness of companies' efforts to create and maintain their "image" -- whether those efforts consisted of public relations or trade shows or sponsoring a football game. I knew that companies potentially were wasting millions of marketing dollars with no clear idea of what they were getting for their money. No one was measuring PR because of the conventional belief that you couldn't measure PR. But I knew that belief was wrong. I knew that combining basic research techniques with sophisticated computer technology could turn a seemingly labor intensive process into a simple, accessible report that quickly illustrated what was working in PR and what was not

Originally, I planned to be a one-person consultancy who worked out of my house But when the idea began to take off, it quickly became apparent that I needed an office, a staff, and sooner than later a loan Of course, it never occurred to me that as a woman, it might be more difficult to borrow money. I arrived in New Hampshire in 1990, having just moved the business out of Boston, and started approaching banks for loans The warnings were direct -- they'll never loan money to a woman with no track record They were wrong Even in a dreadful economic climate, Bank of New Hampshire was willing to bet on my idea, thanks to an SBA loan guarantee. I got the loan, bought a building and began building a company.

Five years later, we had grown to 24 people and were trying to operate out of a 2,200 square foot building We couldn't add clients because we couldn't hire people We couldn't hire people because there was no space to put them For a second time, I ran into a wall

attempting to structure a financial package that would permit the company to expand its operation My best efforts to secure a viable financial structure were unsuccessful. Once again, the SBA came to our rescue. Through its 504 program we were able to obtain long term financing that enabled us to purchase a dilapidated former warehouse and restaurant. It had been vacant for six years -- the former owners left so fast there were still potatoes in the ovens. Six months later, we transformed it into a 9,463 square foot first class office space and brought 25 new jobs to Portsmouth. These people came to work every day, eating lunch, buying supplies and contributing to the local economy. And a derelict building that was a hangout for unsavory elements is now one of the most beautiful offices in New England. With the 504 loan guarantee I was able to complete the project at a total cost in excess of $750,000

In the first year after we moved in, our staff grew by 23 percent and we had increased our revenues by another 40 percent and our profits by 1,000%. That's 9 new jobs in the first year; and we'll hire another 12 employees this year

Our new facility has enabled us to achieve a current annualized revenue of $3 million With annual revenues increasing by 40% per year, we expect to achieve revenue of $10 million dollars in the next five years This level of sales would necessitate an employment level in excess of 50 people.

When a company grows on an average 40% per year, there is a continual crisis with available cash to fund the growth At anytime during one of these periods this company would have been near failure without the loan guarantee from the SBA 504 loan program.

Today, we provide jobs to more than 34 full time people (in addition to a local pool of 50 subcontractors), we pay over $225,000 in federal and state taxes on a million dollar payroll. From our offices in Portsmouth, we influence the spending of millions of marketing dollars in companies such as 3M Corporation, Procter & Gamble, IBM, Hewlett-Packard, Deloitte & Touche and some five dozen more.

The 504 program has been very successful in New Hampshire. On a per capita basis, New Hampshire has received more 504 loan guarantees than any other state in the country My business is one of over 450 companies in New Hampshire that have realized substantial growth as a direct results of financial guarantees received from the 504 program.

In addition to making long term capital available to small businesses, the 504 program is one of the least expensive of all the SBA programs when it comes to expenditure of tax dollars Borrowers of 504 loan guarantee funds pay a small fee which is used to fund insurance coverage in the event a project fails. Consequently, there is virtually little or no risk to the tax payers in the event of a project failure. Another important point to emphasize is the proceed from our 504 loan guarantee came from private lenders and not government funds. In our case the bank first mortgage financing would not have been made without the 504 second mortgage guarantee

The 504 program is not a government handout Rather it is a perfect example of a public and private partnership where private capital is leveraged as a result of government guarantees The 504 program has made a major contribution to the economy and tax base of New Hampshire by making long term financing available to small business The positive economic impact resulting from recipient small businesses is many times what the program has cost the government

Small business in New Hampshire is the engine of job creation, new business growth, and new ideas. The SBA and its 504 loan program has allowed my dream to become a reality. I enthusiastically support its continued funding.

Committee on Small Business

U. S. House of Representatives

TESTIMONY OF

BILL RUETTGERS

PRESIDENT AND CHIEF EXECUTIVE OFFICER

SOUTHERN CAST, INC.

CHARLOTTE, NC

MARCH 9, 1995

Southern Cast, Inc. is a small foundry that existed in Charlotte, NC since the turn of the century. The company specializes in ferrous metal parts, short lead time and small quantities.

- Until 1992, the company was located on Pecan Avenue adjacent to the right of way of Independence Blvd., a major artery through the heart of Charlotte. At that time plans were begun to widen this major road in order to reduce congestion, consequently taking through condemnation the site occupied by Southern Cast's foundry.

- The taking forced Southern Cast to abandon its location and forced it to seek a new suitable location, not an easy task for a foundry filled with heavy machinery and furnaces.

- A site was found that met zoning requirements needed to operate a foundry in the northern industrial area of Charlotte. The building was in great need of repairs to change it into a foundry.

- I knew it would take more money than I could muster, even with the money the state awarded us because with that money I had to pay off all partners and debts from our old site. At that time I realized I needed to borrow about $750,000 to make the whole move and pay for the existing building we wanted to buy and the renovation of it.

- We approached our bank, Southern National, to see if we could borrow the money. At that time we did not have the collateral needed and Southern National recommended we get in partnership with an SBA 504 loan. I had an opportunity to talk with a representative, Mr. Miller, and with all his time and effort and with the help of the bank, the loan was given to us.

- Without the SBA's participation, we would not have found adequate financing to do this project which could have closed us for good. With the help of 504 SBA financing, we were able to move in time without losing any of our existing customers or laying off any employees. We also had some prospective customers make a commitment to move their products with us (OKUMA, SQUARE D, CLARK).

- At the time of our move, we had an average of 15 to 18 employees and a maximum of about 1 million dollars worth of sales. These jobs would have definitely been lost without the participation of the 504 loan.

- Some of the benefits that the loan gave Southern Cast are:

- Since the move, we now employ an average of about 36 employees of which 20 were either homeless or unskilled. Many have a very low education and were on some type of government subsidy (welfare, shelter, food stamps).

- Now these same 20 employees are hard working individuals who come to work every day, pay taxes and receive no free benefits from the government. Also, since our move, we do about 2.5 million dollars worth of sales and have a payroll of about $710,000 a year and annual payroll taxes of about $200,000.

- The company also offers our employees all the benefits that a big company offers: free life insurance, pension program, hospitalization, paid holidays, paid vacation and a yearly bonus just for coming to work every day.

- Our foundry is now a property tax paying asset. We moved to a location in an area of Charlotte where not very many businesses are established, close to the homeless shelter. The area was heavily involved in drugs at one time, but it is in an area where employees can come to work by bus or walking.

- I guess you are talking to one proud business person. Thanks to the support of the 504 loan and Southern National, we have given some people the opportunity to work in Charlotte that might not have had that chance in the past. I think in the future we could go as high as 40 to 50 employees.

- Why you would even consider dropping a program that doesn't cost the government any money blows my mind.

- I want to thank you for the opportunity to come here and speak to you. Also if you really think about it, the money the government was paying to some of our employees to survive was more than the cost of the loan that was given to me to employ these people.

Southern Cast Inc.

Bill and Cheryl Ruettgers, owners
901 N. Church St., Charlotte

When Bill Ruettgers left Pittsburgh for Charlotte in 1983 he had just two things: $600 from a winning lotto ticket and the promise of a job.

A little over a decade later, he's got a bit more: A 36-employee company and the hope of semiretirement by age 60.

"We started the business from scratch," Ruettgers, 52, says of Southern Cast Inc., a foundry he and his wife, Cheryl, own. "And we're still growing. We're probably going to peak out at $3 million" in annual revenue.

The foundry, which uses sand molds to make gray iron and ductile castings, has grown dramatically since the Ruettgers bought it in 1989.


Cheryl Ruettgers


Bill Ruettgers

When Bill first came to town in 1983, he knew little about Charlotte, only that a friend had offered him a chance to run a new foundry. Six years later, when the opportunity arose for the Ruettgers to buy the business, they took a chance and signed on — at the right time.

In 1992, the N.C. Department of Transportation bought the company's old site at 801 Pecan Ave. for a widening project. The Ruettgers took the money, paid off the company's former owners and original loan, and sought help to purchase a new site.

They found help at Southern National Bank and the Small Business Administration, which together loaned the couple $700,000. Now located at 901 N. Church St., the investment seems to have paid off. The company has grown from 20 employees and $1 million in sales in 1992 to 36 and nearly $2.5 million in 1994.

Southern Cast produces 8 tons of cast-n parts a day, making everything from ..ake shoes to doorstops.

The Ruettgers attribute the growth to hard work, knowledge of the industry and word-of-mouth.


Southern Cast Inc. has seen rapid growth. "You have to be very versatile," explains co-owner Cheryl Ruettgers.

"We didn't have the advantages of a huge corporation, so you have to be very versatile," Cheryl says. "You have to be willing to have it be a part of your life."

Bill, president, and Cheryl, vice president, spend six days a week at the foundry, 50 hours on average. Sons William and David, plant and production managers, respectively, work long hours, too.

Finding a good work force and keeping it proved tough during the growing years. Turnover plagued the business. For every three employees hired, one stayed. With unemployment so low in the area, the Ruettgers turned to the homeless shelter for recruitment 2½ years ago. The idea worked: Southern Cast found a large labor pool, and the homeless and jobless found a paycheck.

The foundry requires no experience or education and promises hefty benefits. Salaries start at $5.50 an hour and after 60 days, employees receive hospitalization, paid vacation and holidays, a pension program and often a raise.

Keeping employees is a must for a company that prides itself on quick turnaround. Customers such as Okuma America that hold no inventory on a regular basis rely on Southern Cast for just-in-time delivery. "The delivery is almost 95% on time," says Vann Dacons, a castings buyer for Okuma. "The turnaround for new projects is excellent."

Steve Ingram, a senior buyer specialist for Clark Hurth Components in Statesville, says in emergencies he's had his castings after only three or four days. "Bill's got a niche there that nobody else is getting into," he says. "His business is going to do nothing but grow."

While that's good news, the growth sometimes the hardest part of owning small business, the Ruettgers say.

"The move was quite challenging Cheryl says. "That was long hours. V tried to do as much as we could by ou selves because we didn't want to lay o our employees. It was a very stressf time."

Above all else, the Ruettgers recon mend checking out the labor force a knowing your business. If you don hire someone who does. The Ruettg enlisted Susan Lindsay, a local cons tant, to help them weed their w through government red tape.

"We're very safety-oriented," B says. "We've got two sons out there you have to be."

—*Sarah Sui*

SBA U.S. Small Business Administration Washington, DC 20416

Testimony of

Mary Jean Ryan
Associate Deputy Administrator
for Economic Development
U.S. Small Business Administration

Before

The Committee on Small Business
U.S. House of Representatives

March 9, 1995

Good morning Madam Chairman and Members of the Committee. Thank you for inviting me to appear before you this morning to talk about the U.S. Small Business Administration's (SBA) Certified Development Company (CDC) Loan Program, more commonly known as the 504 program. I am especially happy to talk about the 504 program since it is one with which I have firsthand knowledge. As background, I will also briefly mention the precursors to the 504 program: the 502 and 503 programs.

I began my professional career as a Presidential Management Intern at the SBA and later moved on to become a Business Development Specialist in the SBA's Seattle Regional Office. From 1986 to 1992, I served as Executive Director of the Evergreen Community Development Association, the nation's second largest lender in the SBA's 504 program. Because of my experience with the SBA and with this organization, I have a practical sense of the hurdles facing small businesses and an understanding of why the 504 program has proven so effective.

Since the SBA was established in 1953, one of its charter responsibilities has been to assist small businesses in gaining access to capital. This issue is as critical today as when the Agency was created. Whenever small business entrepreneurs come together, as they are now doing at the White House Conference on Small Business state conferences, one of their top concerns is access to capital.

Small business owners have many different financing needs depending on their stage of development, size, and the type of business in which they engage. Recognizing this, the Congress and the SBA have worked together to establish programs that meet these needs. The financing tools available include, among others: long term, fixed rate asset financing; start-up financing; very small loans or microloans; and venture or patient capital. Today we are addressing the 504 program, which provides small business entrepreneurs with long term, fixed rate asset-based financing. This program is delivered through community-based Certified Development Companies. As you know, hearings will be held later this month on the SBA's pilot Microloan Demonstration program and the Small Business Investment Companies program.

As Administrator Lader has testified before you previously, the SBA is a public\private partnership. The 504 program is one of the SBA's best examples of this partnership approach at work.

504 PROGRAM PURPOSE: LONG TERM FIXED RATE FINANCING

The 504 program is vitally important to the small business community because it provides long term (that is, financing for 10 years or more), fixed interest rate financing for the acquisition of assets -- buildings, facilities and heavy equipment. This program exists because the private market does

not provide sufficient financing for these needs. There are several reasons why lenders do not make these types of loans.

First, since the Savings and Loan crisis and the resulting regulatory response, commercial lenders operate with very conservative loan-to-value (LTV) ratios. A bank's typical LTV terms in the market today are between 66 percent to 80 percent. This means a bank will lend only 66 to 80 percent of the appraised value of what is being financed. Lenders require high down payments, typically 30 percent or more, before they will loan a small business money to buy equipment or facilities. For example, if a building is appraised for $1,000,000, the bank will only make a $700,000 loan. The borrower would have to come up with $300,000. Imagine how few Americans would own homes today if home buyers had to make a 30 percent downpayment on their first home.

Second, commercial lenders frequently do not make long term, fixed rate loans. Because there are often large fluctuations in interest rates over long terms, banks usually make variable rate loans for commercial purposes. A variable interest rate exposes borrowers to an unpredictable payment schedule that can stifle future growth of a small business or contribute to its collapse.

For example, a 2 percentage point rise from 7 percent to 9 percent on a variable rate loan of $700,000 with a 20-year

amortization would raise a borrower's monthly payment by $871. That increase in payment could seriously damage the cash flow of a small business. This drain on cash is very likely to mean that the borrowers would not have adequate working capital to continue normal business operations or to put new facilities into production. This is especially damaging for a firm which is expanding and needs its cash to fund future growth.

HOW THE 504 PROGRAM WORKS

The 504 program is a very efficient use of scarce federal resources because of the private capital that is structured into the program (see chart I attached). In a typical project, a private lender agrees to provide 50 percent of the project cost in exchange for a first lien on the property or equipment being financed. The CDC, with an SBA guaranty, provides a maximum of 40 percent of the project cost and receives a second lien position on the collateral. The borrower provides 10 percent of the project cost in the form of personal or business investment. If we use the example of the $1,000,000 building again, the bank would provide $500,000; the CDC would provide $400,000 guaranteed by the SBA; and the borrower would provide $100,000.

The funding mechanism for the 504 program makes use of the private sector credit markets. Under the 504 program, a CDC issues a debenture which the SBA guarantees. Every month,

debentures from CDCs are guaranteed by the SBA, then pooled and sold to the investment community. The CDCs then make loans to small business borrowers with those proceeds. The borrowers make loan payments to a central processing agent, who then repays the investors that originally purchased the debentures. The CDCs remain responsible for servicing each loan.

504 PROGRAM TRACK RECORD

Since the inception of the CDC program in 1980, the SBA has approved approximately 21,000 loans with the SBA portion totalling nearly $5.9 billion. This investment has leveraged another $10.1 billion in private sector funds. (Chart II illustrates these figures for fiscal years 1991-1994.)

The focus of the 504 program is economic development. The program requires one job to be created or maintained for every $35,000 of financing assistance provided. The Congress, through P.L. 101-574, has also indicated that the program's intent can be met by providing assistance to projects which result in:

- business district revitalization;
- expansion of exports;
- expansion of minority business development;
- rural development;

- enhanced economic competition, including the advancement of technology, plant retooling, conversion to robotics, or competition with imports;
- overcoming changes necessitated by Federal budget cutbacks, including defense related industries;
- assisting business restructuring arising from Federally mandated standards or policies affecting the environment or the safety and health of employees.

As of September 30, 1994, approximately 344,000 jobs had been created or retained as a direct result of funding through the CDC program. Because this program serves growing businesses by financing acquisitions of real property, machinery and equipment, and the construction of production facilities, the tax generation benefits are also very significant.

But, in looking at the impressive 504 lending program numbers, it is important that we not lose sight of the assistance that has been provided one borrower and one loan at a time. A good example of the program's value and importance can be found in the story of Fanfare Enterprises of West Lebanon, New Hampshire.

In 1982, Marty and Carolyn Singer began Fanfare Enterprises, a mail-order business, from their rented home. Like many

start-ups in their industry they lost money during their first five years of operation because they lacked an in-house list of customers. Through trial and error, they were able to compile a valuable list of over one million names nationwide.

As the mailing list grew, the Singers were faced with decisions about hiring more personnel, keeping innovation in their product offerings, acquiring more space, and finding expansion capital to pay for everything they needed. Fanfare Enterprises received a loan of $678,000 through the SBA's 504 program. They used the proceeds to buy a building in West Lebanon, increasing their square footage from 32,000 feet of leased space to 40,000 feet of owned space.

Today Fanfare Enterprises sells music and performing arts related gifts through its catalog, **The Music Stand.** It is a $20 million company with 75 full-time employees and as many as 250 employees during peak seasonal times.

504 PROGRAM FUNDING

Each year Congress provides appropriations for the 504 program. As required by the Federal Credit Reform Act of 1990, the actual appropriated dollars then translate into "lending authority," the total dollar amount of loans that can be guaranteed during the fiscal year. This calculation is based on

the program subsidy rate, which is set annually by the Office of Management and Budget (OMB). It reflects the amount of the reserve that must be established to cover the expected cost to the government of making a given year's loans. This reserve acts as a savings account that the SBA can draw upon if it sustains a loss.

The current subsidy rate for the 504 program is .57 percent. This means that Congress must provide only 57 cents for each $100 of SBA lending authority. The SBA appropriation for fiscal year 1995 provides $1.4 billion in 504 authority at a cost to the taxpayers of only $8 million. This is a real bargain when you consider that it will leverage an additional $2.2 billion in private capital for a total availability of $3.6 billion. That's right: this public\private partnership results in $3.6 billion for small business investment by spending only $8 million of taxpayer dollars.

Additionally, the loss rate for 504 loans is very low. Using the same method of calculation that commercial banks use to identify their losses, the rate is nine tenths of one percent.

504 PROGRAM DELIVERY

There are currently 280 CDCs participating in the 504 program. A CDC applies to cover a specific geographic area and

is granted rights to that area. These entities are the pivotal participants in the program because they are the first level of contact for the borrowers, and they are responsible for putting together the funding packages and for servicing loans.

To be eligible to participate in the 504 program, a CDC must be a not-for-profit corporation dedicated to serving a public purpose. In addition, the CDC must serve a defined area and must have a membership and board that is representative of local Government, businesses, financial institutions and community organizations.

CDCs provide a myriad of financial and technical assistance services to small businesses, and for most CDCs, the 504 program is but one of a series of services provided by the entity.

In many cases CDCs are integral partners with the SBA in the local business community. CDCs may: package SBA 7(a) business loans; serve as SBA micro-lender intermediaries; participate in the SBA's women and minority prequalification programs; and provide other forms of technical assistance, in addition to participating in the 504 program.

Because CDCs have a local focus, the SBA has tried to be flexible enough to allow a variety of lending arrangements. Every CDC must have an ongoing capability to package, process,

close and service 504 fixed asset loans. In addition, it is desirable that the CDC have the capability to: package loans for other Federal and State agencies and private lenders; manage revolving loan funds; serve as a "one stop shop" for rural development if located in a rural area; and marshall any other economic development resources appropriate for the community.

As a result of the SBA's oversight of the program and its desire to maximize its effectiveness, last year, 125 CDCs that made fewer than four loans in the previous two years were given Associate Development Company (ADC) status. This classification restricts development companies from participating fully in the 504 program. However, many ADCs are active in other economic development activities, including other SBA programs.
ADC status recognizes the contribution of these organizations to economic development while allowing small businesses to obtain the benefits of 504 funding from other CDCs which are active in the lending program.

Since the CDC licensing process grants a CDC a specific territory in which to operate, the inactive CDCs essentially precluded small firms in their areas from getting 504 assistance. In situations where the reclassification has motivated the development company to become more active in the 504 program, they may reapply for CDC status again.

HISTORY OF THE CERTIFIED DEVELOPMENT COMPANY PROGRAM

The SBA Development Company programs are authorized by Sections 502, 503 and 504 of Title V of the Small Business Investment Act.

Section 502 authorizes the SBA to guarantee commercial loans made by banks to local development companies which then relend to small businesses. This program is essentially a hybrid of the 504 and the 7(a) programs. Therefore, generally, one of those programs is also able to meet borrowing needs that could be met under the 502 program. Because of this, and the program's limited funding, over the years 502 program usage has decreased. At present the 502 program is operating with very limited activity in only two states -- Georgia and Wisconsin.

Additionally, because of the differences in subsidy rate, the 504 program provides three times more leverage than the 502 program (see chart III attached). For example, the $644 thousand appropriated for the 502 program in fiscal year 1995 will provide $44 million in 502 loans. The same dollars would provide $117 million in the SBA's portion of 504 loans. This amount leverages another $176 million of private capital bringing the total lending available to $293 million.

The current 7(a) and 504 programs have filled the gaps that the 502 program was designed to fill. However, the 502 program lacks the 7(a) requirement that prohibits loans to individuals with significant personal net worth and liquidity, and lacks the 504 program's rigorous economic development standards. The 502 program is also exempt from the recently imposed $500,000 cap on 7(a) and carries lower fees than 7(a). For these reasons, as part of our overall efforts to improve the efficiency and cost effectiveness of the SBA, we have not requested 502 program funding for fiscal year 1996.

The 503 program began in 1980 with the passage of Public Law 96-302, which added Section 503 to Title V of the Small Business Investment Act. The 503 program was designed to improve upon its predecessor, the 502 program.

Under 503 program authority, CDCs obtained program funding through the Federal Financing Bank (FFB) selling debentures guaranteed by the SBA. Unfortunately, a problem existed for some 503 borrowers because of the prepayment premium assessed when borrowers either prepaid a 503 loan or when the SBA honored its guarantee and repurchased a debenture.

This high penalty left many 503 borrowers unable to go forward with additional expansion because they could not afford to pay off the existing 503 loan. The prepayment penalty also

prevented owners from selling their businesses, and in rare cases, heirs were prevented from selling their businesses after the death of the owner.

Last year, thanks to the support of this Committee a bill was adopted, P.L. 103-403, that authorized the SBA to alleviate the prepayment penalties (contractual premiums) for 503 borrowers. The Congress also appropriated $30 million for this purpose (P.L. 103-317). Of the approximately 3,500 borrowers who were eligible to apply, 753 have submitted letters indicating their intent to participate in this one-time prepayment program. Of this number, 530 borrowers have elected to prepay outright, and the remaining 223 have advised the SBA that they intend to refinance their 503 loans with 504 loans.

In accordance with the statutory requirements, all prepayments must be completed by August 10th at which time the refunds will be calculated and distributed to the borrowers. The estimated $51 million needed for refinancing under the 504 program must come out of the fiscal year 1995 budget authority. The SBA is closely monitoring the prepayment program, and will provide Congress with updated information on this initiative during the year.

The 504 program was begun by Public Law 99-272, enacted April 6, 1986. This law created a pilot program for pooling

debentures issued by CDCs and guaranteed by the SBA and selling pass-through certificates in the public market. The first sale was held in November, 1986, and sales have occurred monthly since then. The 504 program became permanent in 1988, replacing the 503 program and providing a different method of funding debentures.

The 504 program also changed the prepayment structure and thus eliminated the problems that existed under the 503 program. Under the 504 program, the prepayment penalty is an amount that is customary in the commercial markets. The SBA pays no premium when it honors its guarantee and repurchases a debenture.

504 PROGRAM IMPROVEMENTS

Two years ago, as part of President Clinton's overall reinvention effort, the SBA took a hard look at all of its lending programs. The Agency conducted a series of Town Hall Meetings to learn the real credit needs of small business and how those needs could be better served. What the Agency learned from its customers was that the programs were well-intentioned, but encumbered by too much paperwork, too many requirements and too little flexibility.

To address these issues in the 504 program, we are currently re-engineering the 504 loan process from beginning to end. Our

goal is to move applications through the loan process as quickly as possible. To realize this goal we are simplifying 504 loan application and closing documents. We are also moving as many functions as possible to CDCs to allow delivery of the program at a pace that fits the needs of the market we all serve.

One aspect of this reinvention effort is the Expedited Closing Procedure that we are currently piloting in Utah and hope to implement nationwide in the next three to four months. The Expedited Closing Procedure allows the experienced attorneys of high volume CDCs to do most of the work of the closing process, thus relieving the burden on SBA counsel and resulting in quicker closings.

Additionally, Public Law 103-403, the SBA's fiscal year 1994 reauthorization bill, authorized the creation of the Accredited Lending and Premier Certified Lenders Programs (ALP and PCLP). These two programs give more responsibility and latitude in loan making to the CDCs. The program is similar to the 7(a) Certified and Preferred Lender Programs (CLP and PLP).

The ALP statute codifies an existing pilot program that allows active CDCs with good track records some discretion to handle processing and servicing actions without SBA involvement. ALP CDCs are also given quicker turn around time on applications and those servicing actions involving the SBA's approval. The

agency has completed drafting the interim final regulations for implementing this pilot.

Additionally, the SBA expects to complete drafting the interim final regulations to implement the PCLP program soon. The legislation creates a program where select CDCs are given the discretion to issue the SBA's authorization for a guaranty without the Agency's prior credit review. The PCLP program will streamline the 504 process and allow CDCs to give faster responses to applicants. Using the examples of private sector lenders, and our experience with centralized processing for Preferred Lender 7(a) loans, the SBA plans to use a centralized loan processing center to handle all PCLP loans.

As you can see we are taking significant steps to improve the delivery of an already well received program that contributes to the long term growth of small business. These streamlined processes reflect the SBA's determination to reach small business customers in the most cost-effective way.

CONCLUSION

Madam Chairman and Committee Members, I believe the SBA's 504 program fills a very important need for access to long term, fixed interest rate asset capital, which is vital to the continued growth of small business in this country.

That concludes my prepared remarks. Again, thank you for the opportunity to testify on the 504 program. I will be happy to answer any questions you may have.

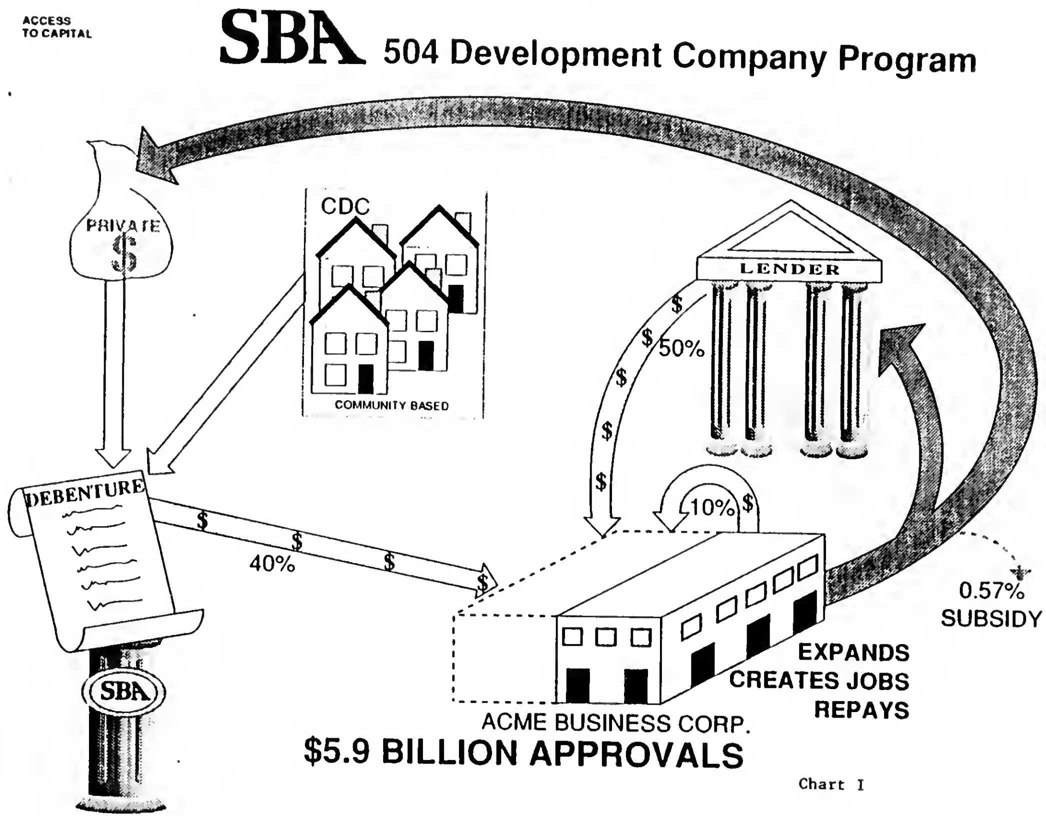

ACCESS TO CAPITAL
SBA 504 Development Company Program
PRIVATE $
CDC
COMMUNITY BASED
LENDER
50%
10%
DEBENTURE
SBA
40%
0.57% SUBSIDY
EXPANDS
CREATES JOBS
REPAYS
ACME BUSINESS CORP.
$5.9 BILLION APPROVALS

Chart I

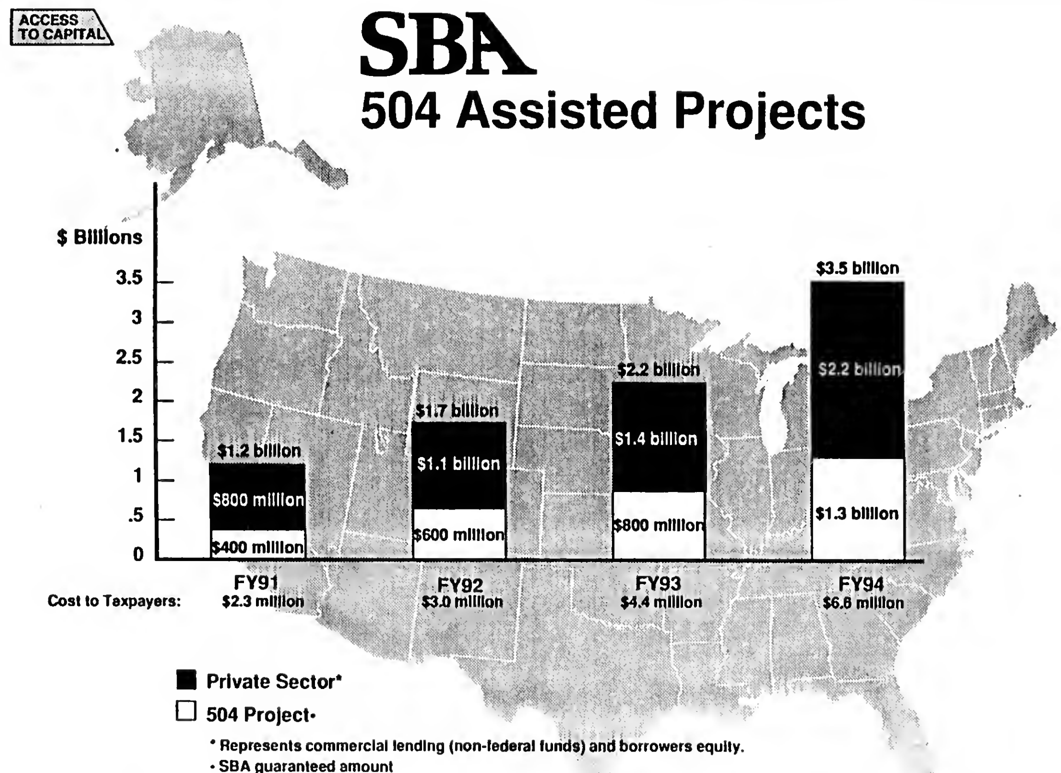
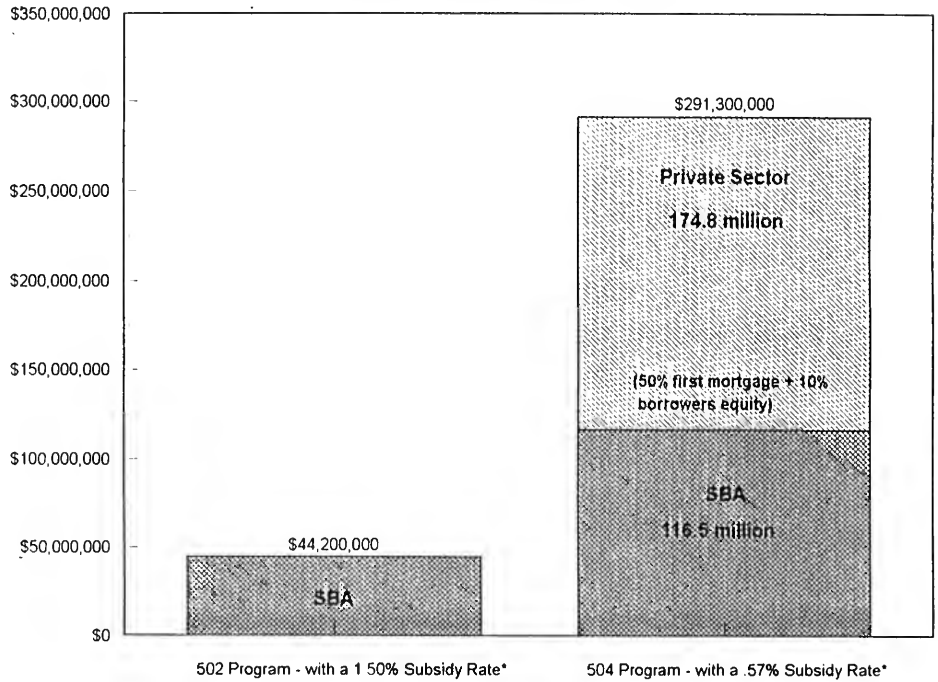

ACCESS TO CAPITAL
SBA
504 Assisted Projects
$ Billions
3.5
3
2.5
2
1.5
1
.5
0
$1.2 billion
$800 million
$400 million
$1.7 billion
$1.1 billion
$600 million
$2.2 billion
$1.4 billion
$800 million
$3.5 billion
$2.2 billion
$1.3 billion
FY91
FY92
FY93
FY94
Cost to Taxpayers:
$2.3 million
$3.0 million
$4.4 million
$6.6 million
Private Sector*
504 Project•
* Represents commercial lending (non-federal funds) and borrowers equity.
• SBA guaranteed amount

Chart II

Small Business Administration

Comparison of FY1995 Subsidy Dollar Usage



*This represents $664,000 in tax payer dollars.

Chart III

ISBN 0-16-047698-4

9 780160 476983 90000